Hedge Funds and Private Equity Funds As Investment Vehicles
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A hedge fund has been defined as a legal entity that allows investors to pool their money together, which is then managed by an investment manager who exploits pricing inefficiencies in the market to generate high returns while trying to assume as little risk as possible.[1] Academics have defined hedge funds as "privately offered, relatively unregulated pooled investment vehicles in the form of limited partnerships or limited liability companies that have the flexibility to invest in a broad range of securities and commodities using a broad range of trading techniques."[2] "Hedge funds" are, however, difficult to define, the term appears nowhere in the federal securities laws, and even industry participants do not agree upon a single definition.[3] Although not easily defined or understood, hedge funds serve as increasingly popular investment vehicles, either through traditional hedge funds or indirectly through funds of hedge funds, both of which present benefits and risks.

[1] Alex R. McClean, Note, "The Extraterritorial Implications of the SEC's New Rule Change to Regulate Hedge Funds," 38 Case W. Res. J. Int'l L. 105, 106 (2006).
[2] Id. at 109.
[3] See, e.g., SEC Roundtable on Hedge Funds (May 13, 2003).

A distinctive feature of hedge funds is their management structure. Unlike mutual funds, which must comply with detailed requirements for independent boards of directors,[4] and whose shareholders must explicitly approve of certain actions,[5] domestic hedge funds are usually structured as limited partnerships to achieve maximum separation of ownership and management. In the typical arrangement, the general partner manages the fund or several funds for a fixed fee and a percentage of the gross profits from the fund. The limited partners are passive investors and generally take no part in management activities.

A private equity fund is structured in a manner similar to a hedge fund. A private equity investment group will structure the form of the private equity fund based upon one of four broad categories: (i) a direct investment fund; (ii) funds of funds; (iii) parallel funds; and (iv) hybrid funds.

I. A Hedge Fund

As already noted, hedge funds are not easily defined or understood, there are certain characteristics that are common among hedge funds. Common among hedge funds are fairly significant initial investment requirements,[6] a limited number of investors,[7] the ability of the fund to invest in a variety of financial instruments,[8] the use of leverage,[9] and the charging of management and performance fees.[10] The management fees charged by funds typically are within the range of 1% to 2% of assets being managed and performance or carried interest fees

[4] 15 U.S.C.S. § 80a-10.
[5] 15 U.S.C.S. § 80a-13.
[6] Id.
[7] Id. The number of investors is usually limited in an effort to avoid registration of the fund under the securities laws (to avoid having to register a fund under section 12 of the Securities Exchange Act of 1934, a fund can have no more than 500 investors, 15 U.S.C. §78(1)). A fund may avoid registration under the Investment Company Act provided its securities are owned by fewer than 100 investors. See 15 U.S.C. 80a-3(c)(1).
[8] See McClean, at 109.
[9] Sargon Daniel, Note, Hedge Fund Registration: Yesterday's Regulatory Schemes for Today's Investment Vehicles, 2007 COLUM. BUS. L. REV. 247, note 7, at 252 (2007).
[10] See Daniel, at 252-53.

may be 20% of the profits interest of the fund (which performance fees are discussed in greater detail in the discussion of a private equity fund).

A significant characteristic among hedge funds is their status as unregulated funds because of the exemptions available under the securities laws. Hedge funds are exempt from registering under section 4(2) of the Securities Act of 1933, which exempts from registration securities sold to sophisticated investors through nonpublic offerings. Hedge funds may avoid registration under the Investment Company Act of 1940 either under 15 U.S.C.S. §80a-3(c)(1), which exempts funds because they have 100 or fewer beneficial owners within the United States and do not offer their securities to the public, or under 15 U.S.C.S. §80a-3(c)(7) because their investors are all qualified high net-worth individuals or institutions. Investment vehicles that remain private and available only to highly sophisticated investors have historically been understood not to present the same dangers to public markets as more widely available investment companies, like mutual funds. Hedge funds can avoid the requirements of filing a registration statement, the requirements to maintain the records required by the Investment Advisors Act, and the requirement for Securities and Exchange Commission (the "SEC") oversight and examinations.[11]

Exemption from regulation under the Investment Company Act of 1940[12] allows hedge funds to engage in different investing behavior than mutual funds. While mutual funds must register with the SEC and disclose their investment positions and financial condition,[13] hedge funds typically remain secretive about their positions and strategies, even to their own investors. The Investment Company Act of 1940 placed significant restrictions on the types of transactions

[11] Registration Under the Advisors Act of Certain Hedge Fund Advisors, Investment Advisors Act Release No. IA-2333 (December 7, 2004) at 3.
[12] 15 U.S.C.S. §80a-1 et seq.
[13] 15 U.S.C.S. §§80a-8, 80a-29.

registered investment companies may undertake. Such companies are, for example, foreclosed from trading on margin,[14] and must secure shareholder approval to take on significant debt or invest in certain types of assets, such as real estate or commodities.[15] Those transactions are central elements of most hedge funds' trading strategies. Hedging transactions involve taking both long and short positions on debt and equity securities to reduce risk. Hedge funds trade in all sorts of assets, from traditional stocks, bonds, and currencies to more exotic financial derivatives and non-financial assets.

However, hedge funds are not free from regulation. Hedge funds are subject to the anti-fraud provisions of the securities laws under the Registration Under the Advisers Act of Certain Hedge Fund Advisers at 3. Also, hedge funds are limited by the terms of the contracts and partnership agreements that govern the funds and the fund managers and by the demands of institutional investors. Institutional investors seek increased disclosure of trading positions, leverage and industry exposure, and more frequent reporting in addition to annual audited reports.[16] Additionally, to attract investments from plan assets managed by fiduciaries under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), hedge funds may be required to become Registered Investment Advisers.[17]

II. Funds of Hedge Funds

A fund of hedge funds (the structure of a fund of hedge funds is similar to a private equity investment group that structures the form of a private equity fund as funds of funds and is discussed later in this article) may be defined as an investment company that pools the assets of

[14] 15 U.S.C.S. §80a-12(a)(1), (3).
[15] 15 U.S.C.S. §80a-13(a)(2).
[16] McClean, at 122, 134.
[17] See Charles J. Gradante, Full Committee Hearing on the "Regulation of the Hedge Fund Industry," THE HENNESSEE GROUP (July 15, 2004).

its investors (similar to a hedge fund) and invests that pool of assets in other funds, rather than in individual securities; in contrast, a hedge fund invests directly in securities.[18] In a speech by Commissioner Atkins of the SEC defined funds of hedge funds as "registered mutual funds whose underlying investments consist of hedge funds."[19] Unlike hedge funds, many funds of hedge funds register their securities with the SEC.[20]

Although funds of hedge funds generally offer shares only to institutional investors, they may be able to make public offerings of their shares, provided they register their shares with the SEC before making any such public offering.

III. Benefits of Hedge Funds and Funds of Funds

Hedge funds and funds of funds offer investors the possibility of greater returns than mutual funds or equities alone may be able to offer. This is due, in large part, because the use of leverage to achieve greater returns by engaging in riskier investment strategies than regulated mutual funds (e.g., exploit temporary price discrepancies in the price of an underlying asset in financial markets), and the ability to invest in a wider range of instruments than mutual funds because hedge funds and funds of hedge funds are not regulated and are not required to seek shareholder approval for investments. Also, hedge fund performance is not tied to the performance of financial markets.

There are also benefits offered specifically by funds of hedge funds. Funds of hedge funds offer greater diversification than do investments in a single hedge fund, which reduces the risk because there is no concentration in a single hedge fund. Funds of hedge funds also appear to register their securities with the SEC more often than individual hedge funds do. This creates

[18] See Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds.
[19] Paul S. Atkins, Commissioner, U.S. Securities and Exchange Commission, Remarks before the ABA Section of Business Law-5th Annual Conference on Private Investment Funds (March 2, 2004).
[20] Id.

more transparency in funds of hedge funds that does not exist for hedge funds since registered funds are required to provide prospectuses to their investors and are required to file reports with the SEC on a quarterly basis. Also, funds of hedge funds make investment in hedge funds more accessible to more investors because there is a lower threshold for a minimum investment and less likely that there is a required period for the investment.

IV. Risks of Hedge Funds and Fund of Funds

The greatest risk regarding hedge funds is the lack of regulation and oversight by the SEC. However, there is a view that the majority of the investors in hedge funds are institutional investors and are sophisticated investors. Chairman of the Federal Reserve Ben Bernanke stated:

> In the case of hedge funds, securities laws effectively allow only institutions and high-wealth individuals to invest in them. These investors generally have the resources and sophistication, as well as the incentive, to monitor the activities of the hedge funds. Large investors are not only well equipped to assess the management, strategies, performance, risk-management practices, and fee structures of individual hedge funds but they also have the clout to demand the information they need to make their evaluations.[21]

The lack of regulation also produces a lack of transparency. Another drawback is the performance fees. This is particularly the case with funds of hedge funds. A fund of hedge funds charges investors a set of fees for investing in the fund of hedge funds and then also passes along to investors the fees charged by the underlying hedge funds in which the fund of hedge fund invests.

V. Regulation Under ERISA

Under section 404 of ERISA, fiduciary duties are imposed on those who exercise control over plan assets. However, exempt from ERISA fiduciary status are registered investment companies, which will generally not benefit hedge funds because they are not registered

[21] Hedge Fund Regulation (April 12, 2007).

investment companies. A hedge fund manager may avoid ERISA fiduciary status if the investment entity, the hedge fund, provides that the investments in the entity by pension funds are not "significant." A "significant" investment is considered to exist any time a pension plan holds "25% or more of the value of any class of equity interests in an invested entity."[22] As a result, hedge funds can limit plan investments in them to benefit from this exception.

The requirement for diversification is also imposed on pension plans to prevent investments of all or substantially all of their assets in any one security or group of securities which are tied to the performance of a single industry or area.

Although allocation of assets in a hedge fund is acceptable for pension plans and other fiduciary trusts, there is an argument that it may result in a breach of trustee fiduciary duty to invest in hedge funds through a fund of hedge fund. This is because it may compromise the trust fiduciary's duty of delegation and prudence in selecting and monitoring performance of a service provider under ERISA and the Uniform Prudent Investor Act.[23] Once the duty of due diligence has been completed, the trust fiduciary has an ongoing duty to monitor the performance of the selected investment manager and review the actions of the investment manager to ensure compliance with the terms and scope of the delegation, which may not be easy with investments in a fund of hedge funds.[24]

VI. A Private Equity Fund

Typically, a private equity investment group that structures the form of a private equity fund as a direct investment fund will organize the fund as a limited partnership, a limited liability

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[22] Crenshaw, Note, Hedge Funds: Regulatory, Tax and Organizational Considerations, 18 Fla. J. Int'l L. 359, 391 (2006).
[23] Charles J. Gradante, "Fund of Hedge Funds Imprudent for Fiduciaries," THE HENNESSEE GROUP (June 2002).
[24] Id.

company or other form of pass-through entity for United States tax purposes. The fund will have a fixed investment period, for example, seven to ten years, reflecting the expected holding period of the portfolio investments. Generally, fund investors will allocate capital earmarked for specific private equity funds, in particular, investments within narrow sectors of the market. A direct investment fund also may be structured to invest directly into a specific investment or fund, or may invest a portion of its capital in a funds of funds, or in a parallel vehicle for special investments or for specific types of investors such as tax-exempt investors. Funds of funds is an entity form established for the sole purpose of investing in other private equity funds in order to spread the risk and consequently, the reward. A parallel fund is generally structured in a manner to serve the special tax objectives of a tax-exempt investor or a foreign investor to retain the desired tax consequences. Except as necessary to accommodate those objectives, parallel funds do not differ from other fund prototypes in basic objective investments or expected investment period. A hybrid fund is a fund that merges two or more of the basic categories within a single entity.

The purpose of a private equity fund will include a wide-range of investment categories, such as: (i) a venture capital fund; or a (ii) leveraged buyout fund. A venture capital fund is probably the most conventional form for a private equity fund. A venture capital fund will invest capital in a privately owned business during the early stages of product or service development. The business initially will generate losses in the expectation of revenue growth and market share and will consequently, lack the necessary cash flow to rely on more conventional financing sources, such as banks or other institutional lenders. A leverage buyout fund will invest primarily in established businesses with substantial borrowing capacity. In a typical investment, the fund will acquire a controlling interest in the business in order to develop the business and sell the business at a later date of the fund's choosing. The fund will usually organize a corporate acquisition vehicle, which then will acquire the stock or assets of the portfolio company.

The investors in a private equity fund generally will not invest the entire capital commitment at once; instead, there is a commitment to invest a fixed amount of capital in stages, commonly referred to as the "investment period."

When the private equity fund sells investments, which may include the controlling interest in a business, the profits (or losses) are determined. The economic agreement that governs the distribution of the proceeds by the fund, whether in the form of cash or marketable securities, is referred to as the "distribution waterfall." Investors in a private equity fund will achieve liquidity as and when the fund sells its investments. Return of capital distributions will usually follow one of three methodologies: (i) investment-by-investment; (ii) realized aggregation; or (iii) full aggregation.

A private equity fund that distributes proceeds based upon the investment- by-investment methodology will reimburse capital and expenses allocable only to the sold investment. The following example illustrates an investment-by-investment methodology.

> Assume a fund that provides for a 20% profits interest makes three portfolio investments at a cost of $20 million each in A, B and C. At the end of year two, it sells A for $16 million. At the end of year three, it sells B for $30 million. Assume no management fee or other fees and expenses. At the end of year two, the fund will distribute the entire $16 million to the investors. At the end of year three, the fund will distribute $20 million to the investors, $2 million to the general partner and $8 million to the investors. The fund therefore distributes 20% of the aggregate $10 million gain on B to the general partner even though it has realized a net gain of only $6 million.

Because this distribution methodology will allow the general partner to participate in investment proceeds even if the fund has not yet realized a net gain, few private equity funds use this methodology.

In a fund that aggregates gains and losses on realized investments, the fund will first distribute investment proceeds to reimburse capital and expenses allocable to the investment and then reimburse unrecovered losses on prior sales. The following example illustrates this methodology.

> Assume a fund that provides for a 20% profits interest again makes three portfolio investments at a cost of $20 million each in A, B and C. At the end of year two, it sells A for $16 million. At the end of year three, it sells B for $30 million. Assume no management fees or other fees and expenses. At the end of year two, the fund will distribute the entire $16 million to the investors. At the end of year three, the fund will distribute $24 million to the investors, $1.2 million to the general partner and $4.8 million to the investors. Although the fund has realized a gain of $10 million on B, the gain exceeds previous losses by only $6 million. To reimburse the investors for the $4 million of loss on A, therefore, the fund will distribute the first $4 million of gain on B to the investors.

In a fund that provides for full aggregation, the general partner will receive carry distributions only after the fund reimburses all invested capital, not merely capital allocable to previously sold investments. The following example illustrates this methodology.

> Assume a fund that provides for a 20% profits interest again makes three portfolio investments at a cost of $20 million each in A, B and C. At the end of year two, it sells A for $24 million. At the end of year three, it sells B for $30 million. Assume no management fees or other fees and expenses. At the end of years two and three, the fund will distribute the entire $24 million and $30 million to the investors even though it has realized a $14 million gain because total invested capital (i.e., $60 million) still exceeds total investment proceeds (i.e., $54 million). The fund will then distribute 20% of any investment proceeds on C in excess of $6 million to the general partner in respect of the profits interest.

Regardless of the distribution methodology (i.e., investment- by-investment, realized aggregation, full aggregation) the general partner will not earn its profits interest until the fund returns aggregate invested capital to its investors. The reason is that the general partner "earns" the profits interest only if aggregate investment gains exceed aggregate losses.

Despite the relative uncertainty of the realization of investment gains or losses, a private equity fund that distributes either on an "investment-by-investment" or "realized aggregation" basis will allow current distributions to the general partner. The assumption implicit in such a private equity fund is that the retained investments will ultimately realize gains at least sufficient to reimburse any remaining unreturned capital. This may produce excess distributions to the general partner during periods that precede the liquidation of the fund. The effect of such distributions is to reward the general partner for accelerating the sale of investments that realize a gain and deferring the sale of investments that have not yet realized a gain by providing its investors with the interim use of the funds. Consequently, in order to reconcile the aggregation of gains and losses with respect to the investments, a private equity fund will impose a "clawback" obligation. To reconcile the aggregate nature of the profits interest with the market practice of distributing proceeds on an "investment-by-investment" or "realized aggregation" basis, the private equity fund will "clawback" earlier distributions made to the general partner.

Assuming that the fund has properly allocated profit and loss, a general partner that contributes no capital to the fund generally will have a negative capital account at liquidation equal to its unearned distributions. Therefore, in a private equity fund that provides for a clawback, the general partner and its investors are required to restore earlier distributions, which the fund will then redistribute to the investors who have contributed capital to the fund. The following example illustrates the effect of a clawback.

> Assume a fund that provides for a 20% profits interest to the general partner makes three portfolio investments at a cost of $20 million each in A, B and C. Assume that the fund distributes investment proceeds on a "realized aggregation" basis. At the end of year one, it sells A for $30 million, distributing $20 million

to the investors to reimburse capital allocable to A and the remaining $10 million, 80% to the investors (i.e., $8 million) and 20% to the general partner (i.e., $2 million) in respect of its profits interest. At the end of year two, it sells B for $24 million and distributes $20 million to the investors to reimburse capital allocable to B and the remaining $4 million, 80% to the investors (i.e., $3.2 million) and 20% to the general partner (i.e., $.8 million) in respect of its profits interest. At the end of year three, the fund sells C for $8 million and liquidates. When it distributes the full proceeds to the investors, the investors will have received aggregate distributions of only $59.2 million (i.e., $20 million + $8 million + $20 million + 3.2 million + $8 million), which is less than the $60 million of invested capital. The fund therefore requires the exercise of the clawback provision. Because the fund realized a net gain of only $2 million ($62 million - $60 million) over the life of the venture, the general partner should have received only $0.4 million, not $2.8 million. The general partner therefore returns $2.4 million to the fund for redistribution to the investors.

VII. Making Hedge Funds and Private Equity Funds a Safer Investment

To make hedge funds safer investment choices for pension funds is to increase the transparency of hedge funds. In an attempt to gain greater regulatory control over hedge funds, the SEC enacted a rule under the Investment Advisers Act of 1940, 15 U.S.C.S. §80b-1 et seq., that became effective in February 2006 requiring nearly all hedge fund managers to register with the SEC. The new rule re-defined the term “clients” to have broader application and caused most advisers to hedge funds to register with the SEC if the funds they advised had 15 or more shareholders, limited partners, or members, but managers that required a two year lock-up could avoid registration.[25] The registration rule was adopted in late 2004, but the SEC gave the industry more than a year to prepare for being a registered investment adviser. During that time, the SEC was sued by hedge fund manager Phil Goldstein over the new rule, and in a ruling issued in June of 2006, the U.S. Court of Appeals for the District of Columbia vacated the hedge fund rule.[26] The court stated that the SEC too broadly interpreted “clients” for hedge funds and that by “painting with such a broad brush, the Commission has failed adequately to justify

[25] 17 C.F.R. §275.203(b)(3)-2(a).
[26] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

departing from its own prior interpretation of §203(b)(3)."[27] The court stated that absent any justification, the choice by the Commission appeared "completely arbitrary." The decision was not appealed. The SEC staff subsequently issued a "no-action" letter to the industry to reinstate certain aspects of the vacated rule and vowed to find another way to regulate hedge funds. However, in a form of self-regulation, hedge fund managers have been registering with the SEC on a voluntary basis to attract investments from pension plans.

Transparency may also be improved by requiring greater disclosure from hedge funds that have a certain percentage of assets derived from pension funds. Hedge funds that receive investments surpassing the specified threshold would need to disclose information on investment strategies, asset allocations, fund performance, and fees charged.

Hedge funds would also need to provide pension funds with exit options in the event hedge funds encounter negative performance. Pension funds may not want to commit assets to hedge funds because they become subject to lock-in periods, which prevent a withdrawal of investments before the expiration of a stated period and substantial penalty charges. Exit options may be more difficult with respect to private equity funds because of the distribution waterfall, but perhaps plan assets could be invested only in private equity funds that impose a full aggregation distribution methodology.

Additionally, limits could be placed on the percentage of fund assets which pension fiduciaries are permitted to invest in hedge funds and private equity funds. The Department of Labor could require increased disclosure on the part of pension funds, requiring that they disclose to beneficiaries the number of hedge funds and private equity funds in which they have invested pension fund assets and the amounts invested in each.

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[27] Id.

Also, it is possible that hedge funds, and possibly even private equity funds, may retain their assets in off-shore accounts, such as the Cayman Islands, and if that would be the case and the hedge fund experiences problems, the assets may not be reached. So, limitations may need to be placed on the assets of a hedge fund that are held off-shore.

VIII. Goldstein v. SEC, A Closer Look at Regulation

A closer look at the Goldstein case may be useful in the consideration of the regulation of hedge funds and private equity funds to promote or produce transparency.

On Petition for Review of an Order of the Securities and Exchange Commission, the petition for review was granted, and the Hedge Fund Rule was vacated and remanded.

Petitioners, investment firm and hedge fund, sought review of respondent Securities and Exchange Commission's (SEC) regulation of hedge funds under the Investment Advisers Act of 1940, 15 U.S.C.S. § 80b-1 et seq. Previously exempt because they had fewer than 15 clients, most advisers to hedge funds would have to register with the SEC if the funds they advised had 15 or more shareholders, limited partners, or members under 17 C.F.R. § 275.203(b)(3)-2(a).

Upon concluding that its regulatory program for hedge fund advisers was inadequate, the SEC promulgated the Hedge Fund Rule, which specified that for purposes of § 203(b)(3) (15 U.S.C.S. § 80b-3(b)(3)) of the Investment Advisers Act of 1940, 15 U.S.C.S. § 80b-1 et seq., advisers were required to count as clients the shareholders, limited partners, members, or beneficiaries of the fund under 17 C.F.R. § 275.203(b)(3)-2(a). The court found that even if the Advisers Act did not foreclose the SEC's equation of "client" with "investor", the interpretation fell outside the bounds of reasonableness where the SEC's interpretation came close to violating the plain language of the statute since § 206 (15 U.S.C.S. § 80b-6) of the Advisers Act made it unlawful for any investment adviser, registered or not, to engage in any transaction, practice, or course of business which operated as a fraud or deceit upon any client or prospective client, and the SEC could not explain why “client” should mean one thing when determining to whom fiduciary duties were owed, and something else entirely when determining whether an investment adviser had to register under the Act.

The case involved a petition for review of the Securities and Exchange Commission’s regulation of “hedge funds” under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 et seq. (See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279) (“Hedge Fund Rule”)). The court stated that previously exempt because they had “fewer than fifteen clients,” 15 U.S.C. § 80b-3(b)(3), most advisers to hedge funds were required to register with the Commission if the funds they advised had fifteen or more “shareholders, limited partners, members, or beneficiaries” under 17 C.F.R. § 275.203(b)(3)-2(a). Petitioners Philip Goldstein, an investment advisory firm Goldstein co-owned (Kimball & Winthrop), and Opportunity Partners L.P., a hedge fund in which Kimball & Winthrop was the general partner and investment adviser (collectively “Goldstein”) challenged the regulation’s equation of “client” with “investor.”

The court stated that “hedge funds” were notoriously difficult to define, the term appeared nowhere in the federal securities laws, and even industry participants could not agree upon a single definition. See, e.g., SEC Roundtable on Hedge Funds (May 13, 2003) (comments of David A. Vaughan), available at http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm (citing fourteen different definitions found in government and industry publications). The court stated that the term was commonly used as a catch-all for “any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public." PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE

LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999) ("Working Group Report"); 451 F.3d 873, *; 371 U.S. App. D.C. 358, **; 2006 U.S. App. LEXIS 15760, ***1; Fed. Sec. L. Rep. (CCH) P93,890 see also IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 3 (2003) ("Staff Report") (defining "hedge fund" as "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").

The court stated that hedge funds could be defined more precisely by reference to what they were not. The Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq., directed the Commission to regulate any issuer of securities that "is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities." Id. § 80a-3(a)(1)(A). Although this definition nominally described hedge funds, most were exempt from the Investment Company Act's coverage because they had one hundred or fewer beneficial owners and did not offer their securities to the public, id. § 80a-3(c)(1), or because their investors were all "qualified" high net-worth individuals or institutions, id. § 80a-3(c)(7).[28] Investment vehicles that remained private and available only to highly sophisticated investors had historically been understood not to present the same dangers to public markets as more widely available investment companies, like mutual funds.[29] See Staff Report, supra, at 11-12, 13.

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[28] Hedge funds are usually differentiated from other exempted investment vehicles like private equity or venture capital funds by their investing and governance behavior. See Hedge Fund Rule, 69 Fed. Reg. at 72,073 nn.224-225.

[29] Mutual funds make up the vast majority of registered investment companies, with about $6.4 trillion under management in December 2002. See Staff Report, supra, at 1 n.4. Although precise data are unavailable, some

The court stated that exemption from regulation under the Investment Company Act allowed hedge funds to engage in very different investing behavior than their mutual fund counterparts. While mutual funds, for example, were required to register with the Commission and disclose their investment positions and financial condition, id. §§ 80a-8, 80a-29, hedge funds typically remained secretive about their positions and strategies, even to their own investors. See Staff Report, supra, at 46-47. The Investment Company Act placed significant restrictions on the types of transactions registered investment companies could undertake. Such companies were, for example, foreclosed from trading on margin or engaging in short sales, 15 U.S.C. § 80a-12(a)(1), (3), and were required to secure shareholder approval to take on significant debt or invest in certain types of assets, such as real estate or commodities, id. § 80a-13(a)(2). These transactions were all core elements of most hedge funds' trading strategies. See Staff Report, supra, at 33-43. "Hedging" transactions, from which the term "hedge fund" developed, see Willa E. Gibson, Is Hedge Fund Regulation Necessary?, 73 TEMP. L. REV. 681, 684-85 & n.18 (2000), involve taking both long and short positions on debt and equity securities to reduce risk. The court stated that this was still the most frequently used hedge fund strategy, see Staff Report, supra, at 35, though there were many others. The court stated that hedge funds traded in all sorts of assets, from traditional stocks, bonds, and currencies to more exotic financial derivatives and even non-financial assets. See, e.g., Kate Kelly, Creative Financing: Defying the Odds, Hedge Funds Bet Billions on Movies, WALL ST. J., Apr. 29, 2006, at A1. Hedge funds often used leverage to increase their returns.

estimates of the size of the hedge fund industry range from about $600 billion, id., to close to $900 billion, Hedge Fund Rule, 69 Fed. Reg. at 72, 055 & n.20.

The court stated that another distinctive feature of hedge funds was their management structure. Unlike mutual funds, which were required to comply with detailed requirements for independent boards of directors, 15 U.S.C. § 80a-10, and whose shareholders must explicitly approve of certain actions, id. § 80a-13, domestic hedge funds were usually structured as limited partnerships to achieve maximum separation of ownership and management. In the typical arrangement, the general partner managed the fund (or several funds) for a fixed fee and a percentage of the gross profits from the fund. The limited partners were passive investors and generally took no part in management activities. See Staff Report, supra, at 9-10, 61.

The court stated that hedge fund advisers also had been exempt from regulation under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 et seq. ("Advisers Act"), a companion statute to the Investment Company Act, and the statute which was the primary focus of this case. Enacted by Congress to "substitute a philosophy of full disclosure for the philosophy of caveat emptor" in the investment advisory profession, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186, 84 S. Ct. 275, 451 F.3d 873, *875; 371 U.S. App. D.C. 358, **360; 2006 U.S. App. LEXIS 15760, ***3; Fed. Sec. L. Rep. (CCH) P93, 890 11 L. Ed. 2d 237 (1963), the Advisers Act was mainly a registration and anti-fraud statute. Non-exempt "investment advisers" were required to register with the Commission, 15 U.S.C. § 80b-3, and all advisers were prohibited from engaging in fraudulent or deceptive practices, id. § 80b-6. By keeping a census of advisers, the Commission could better respond to, initiate, and take remedial action on complaints against fraudulent advisers. See id. § 80b-4 (authorizing the Commission to examine registered advisers' records).

The court stated that hedge fund general partners met the definition of "investment adviser" in the Advisers Act. See 15 U.S.C. § 80b-2(11) (defining "investment adviser" as one 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"); Abrahamson v. Fleschner, 568 F.2d 862, 869-71 (2d Cir. 1977) (holding that hedge fund general partners are "investment advisers"), overruled in part on other grounds by Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 100 S. Ct. 242, 62 L. Ed. 2d 146 (1979). But they usually satisfied the "private adviser exemption" from registration in § 203(b)(3) of the Act, 15 U.S.C. § 80b-3(b)(3). That section exempted "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under [the Investment Company Act]." Id. As applied to limited partnerships and other entities, the Commission had interpreted this provision to refer to the partnership or entity itself as the adviser's "client." See 17 C.F.R. § 275.203(b)(3)-1. The court stated that even the largest hedge fund managers usually ran fewer than fifteen hedge funds and were therefore exempt.

The court stated that although the Commission had a history of interest in hedge funds, see Staff Report, supra, at app. A, the push for regulation had its origins in the failure of Long-Term Capital Management, a Greenwich, Connecticut-based fund that had more than $125 billion in assets under management at its peak. In late 1998, the fund nearly collapsed. Almost all of the country's major financial institutions were put at risk due to their credit exposure to Long-Term, and the president of the Federal Reserve Bank of New York personally intervened to engineer a bailout of the fund in order to avoid a national financial crisis. See generally ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000).

The court stated that a joint working group of the major federal financial regulators produced a report recommending regulatory changes to the regime governing hedge funds, and the Commission's staff followed with its own report about the state of hedge fund regulation. Drawing on the conclusions in the Staff Report, the Commission – over the dissent of two of its members -- issued the rule under review in December 2004 after notice and comment. The Commission cited three recent shifts in the hedge fund industry to justify the need for increased regulation. First, despite the failure of Long-Term Capital Management, hedge fund assets grew by 260 percent from 1999 to 2004. Hedge Fund Rule, 69 Fed. Reg. at 72,055. Second, the Commission noticed a trend toward "retailization" of hedge funds that increased the exposure of ordinary investors to such funds. The court stated that this retailization was driven by hedge funds loosening their investment requirements, the birth of "funds of hedge funds" that offered shares to the public, and increased investment in hedge funds by pension funds, universities, endowments, foundations and other charitable organizations. See id. at 72,057-58. Third, the Commission was concerned about an increase in the number of fraud actions brought against hedge funds. See id. at 72,056-57. Concluding that its "current regulatory program for hedge fund advisers [was] inadequate," id. at 72,059, the Commission moved to require hedge fund advisers to register under the Advisers Act so that it could gather "basic information about hedge fund advisers and the hedge fund industry," "oversee hedge fund advisers," and "deter or detect fraud by unregistered hedge fund advisers," id.

The court stated that the Hedge Fund Rule first defined a "private fund" as an investment company that (a) was exempt from registration under the Investment Company Act by virtue of having fewer than one hundred investors or only qualified investors, see 15 U.S.C. § 80a-3(c)(1), (7); (b) permitted its investors to redeem their interests within two years of investing; and (c) marketed itself on the basis of the "skills, ability or expertise of the investment adviser." 17 C.F.R. § 275.203(b)(3)-1(d)(1). For these private funds, the rule then specified that "[f]or purposes of section 203(b)(3) of the [Advisers] Act (15 U.S.C. § 80b-3(b)(3)), advisers were required to count as clients the shareholders, limited partners, members, or beneficiaries . . . 451 F.3d 873, *876; 371 U.S. App. D.C. 358, **361; 2006 U.S. App. LEXIS 15760, ***7; Fed. Sec. L. Rep. (CCH) P93,890 of [the] fund." Id. § 275.203(b)(3)-2(a). The rule had the effect of requiring most hedge fund advisers to register by February 1, 2006.[30]

The court stated that the dissenting Commissioners disputed the factual predicates for the new rule and its wisdom. Goldstein made some of the same points but the major thrust of his complaint was that the Commission's action misinterpreted § 203(b)(3) of the Advisers Act, a charge the Commission dissenters also leveled. This provision exempted from registration "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients." 15 U.S.C. § 80b-3(b)(3) (emphasis added). The Act did not define "client." Relying on Chevron U.S.A. Inc. v. NRDC, 467 U.S. 837, 842-43, 104 S. Ct. 2778, 81 L. Ed. 2d 694 (1984), the Commission believed this rendered the statute "ambiguous as to a method for counting clients." Br. for Resp. 21. The court stated that there was no such rule of law. The lack of a statutory definition of a word did not necessarily render the meaning of a word ambiguous, just as the presence of a definition did not necessarily make the meaning clear. A definition only pushed the problem back to the meaning of the defining terms. See Alarm Indus. Commc'ns Comm. v. FCC, 327 U.S. App. D.C. 412, 131 F.3d 1066, 1068-70 (D.C. Cir. 1997);

[30] Application of the rule also triggers certain regulations that apply only to registered advisers. Most importantly, registered advisers must open their records to the Commission upon request, 15 U.S.C. § 80b-4, and cannot charge their clients a performance fee unless such clients have a net worth of at least $ 1.5 million or at least $750,000 under management with the adviser. Id. § 80b-5; 17 C.F.R. § 275.205-3; see also Hedge Fund Rule, 69 Fed. Reg. at 72,064 (citing "salutary effect" of this rule to limit "retailization").

Doris Day Animal League v. Veneman, 354 U.S. App. D.C. 216, 315 F.3d 297, 298-99 (D.C. Cir. 2003).

The court stated that if Congress employed a term susceptible of several meanings, as many terms were, it scarcely followed that Congress had authorized an agency to choose any one of those meanings. As always, the "words of the statute should be read in context, the statute's place in the overall statutory scheme should be considered, and the problem Congress sought to solve should be taken into account" to determine whether Congress had foreclosed the agency's interpretation. PDK Labs. Inc. v. DEA, 360 U.S. App. D.C. 344, 362 F.3d 786, 796 (D.C. Cir. 2004) ("PDK I") (internal quotation marks omitted).

The court stated that the term "client" could mean different things depending on context. The client of a laundry occupied a very different position than the client of a lawyer. Even for professional representation, the specific indicia of a client relationship -- contracts, fees, duties, and the like -- varied with the profession and with the particulars of the situation. An attorney-client relationship, for example, could be formed without any signs of formal "employment." See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 14 & cmt. c (2000) ("The client need not necessarily pay or agree to pay the lawyer; and paying a lawyer does not by itself create a client-lawyer relationship . . .."). Matters could be very different for the client of, say, an architectural firm.

The court stated that the Commission believed that an amendment to § 203(b)(3) suggested the possibility that an investor in a hedge fund could be counted as a client of the fund's adviser. In 1980, Congress added to § 203(b)(3) the following language: "For 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."[31] Act of Oct. 21, 1980, Pub. L. No. 96-477, § 202, 94 Stat. 2275, 2290 (1980). This language was inserted against a backdrop of uncertainty created by the Second Circuit's decision in Abrahamson v. Fleschner. The Abrahamson court held that hedge fund general partners were "investment advisers" under the Advisers Act, 568 F.2d at 869-71. In its original opinion, the court specified that the general partners were advisers "to the limited partners." See Robert C. Hacker & Ronald D. Rotunda, SEC Registration of Private Investment Partnerships After Abrahamson v. Fleschner, 78 COLUM. L. REV. 1471, 1484 n.72 (1978). The final published opinion omitted those four words, see Abrahamson, 568 F.2d at 871 n.16, suggesting that the court expressly declined to resolve any ambiguity in the term "client." The court stated that Congress was aware of this judicial confusion, see, e.g., Beethoven.com LLC v. Librarian of Congress, 364 U.S. App. D.C. 295, 394 F.3d 939, 945-46 (D.C. Cir. 2005), 451 F.3d 873, *877; 371 U.S. App. D.C. 358, **362; 2006 U.S. App. LEXIS 15760, ***12; Fed. Sec. L. Rep. (CCH) P93, 890 the 1980 amendment could be seen as Congress's acknowledgment that "client" was ambiguous in the context of § 203(b)(3). There were statements in the legislative history that suggest as much. See, e.g., H.R. REP. NO. 96-1341, at 62 (1980) ("[W]ith respect to persons or firms which do not advise business development companies, the . . . amendment . . . is not intended to suggest that each shareholder, partner, or beneficial owner of a company advised by such person or firm should or should not be regarded as a client . . .."). Although "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one," PDK I,

[31] A "business development company" -- commonly known as a venture capital company -- is defined in 15 U.S.C. § 80a-2(a)(48) as a "closed-end company which" operates for the purpose of making investments in certain securities and making "available significant managerial assistance with respect to the issuers of such securities."

362 F.3d at 794-95 (quoting United States v. Price, 361 U.S. 304, 313, 80 S. Ct. 326, 4 L. Ed. 2d 334, 1960-1 C.B. 701 (1960)), the 1980 amendment might be seen as introducing another definitional possibility into the statute. See PDK Labs. Inc. v. DEA, 370 U.S. App. D.C. 47, 438 F.3d 1184, 1192-93 (D.C. Cir. 2006).[32]

The court stated that, on the other hand, a 1970 amendment to § 203 appeared to reflect Congress's understanding at the time that investment company entities, not their shareholders, were the advisers' clients. In the amendment, Congress eliminated a separate exemption from registration for advisers who advised only investment companies and explicitly made the fewer-than-fifteen-clients exemption unavailable to such advisers. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 24, 84 Stat. 1413, 1430 (1970). This latter prohibition would have been unnecessary if the shareholders of investment companies could be counted as "clients."

The court stated that another section of the Advisers Act strongly suggested that Congress did not intend "shareholders, limited partners, members, or beneficiaries" of a hedge fund to be counted as "clients." Although the statute did not define "client," it did define "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." 15 U.S.C. § 80b-2(11) (emphasis added). An investor in a private fund could benefit from the adviser's advice (or he may suffer

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[32] There is irony in the Commission's reliance on this amendment to demonstrate the ambiguity of "client." The Commission in 1985 established a "safe harbor," allowing advisers to count certain limited partnerships as single clients specifically in order to provide "greater certainty" about the meaning of the term. Definition of "Client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 Fed. Reg. 8740, 8740 (Mar. 5, 1985) ("Safe Harbor Proposed Rule"). In so doing, the Commission declared that it "should [not] distinguish such a limited partnership from a business development partnership," and that it was therefore "incorporat[ing] the approach of the 1980 Amendments into a limited partnership rule." Id. at 8741.

from it) but he did not receive the advice directly. He invested a portion of his assets in the fund. The fund manager -- the adviser -- controled the disposition of the pool of capital in the fund. The adviser did not tell the investor how to spend his money; the investor made that decision when he invested in the fund. Having bought into the fund, the investor faded into the background; his role was completely passive. If the person or entity controlling the fund was not an "investment adviser" to each individual investor, then a fortiori each investor could not be a "client" of that person or entity. The court stated that these were just two sides of the same coin.

The court stated this had been the Commission's view until it issued the new rule. As recently as 1997, it 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." Status of Investment Advisory Programs Under the Investment Company Act of 1940, 62 Fed. Reg. 15,098, 15,102 (Mar. 31, 1997). The Commission said much the same in 1985 when it promulgated a rule with respect to 451 F.3d 873, *879; 371 U.S. App. D.C. 358, **364; 2006 U.S. App. LEXIS 15760, ***16; Fed. Sec. L. Rep. (CCH) P93, 890 investment companies set up as limited partnerships rather than as corporations. The "client" for purposes of the fifteen-client rule of § 203(b)(3) was the limited partnership not the individual partners. See 17 C.F.R. § 275.203(b)(3)-1(a)(2). As the Commission wrote in proposing the 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." Safe Harbor Proposed Rule, 50 Fed. Reg. at 8741.

The court stated that the Supreme Court embraced a similar conception of the adviser-client relationship when it held in Lowe v. SEC, 472 U.S. 181, 105 S. Ct. 2557, 86 L. Ed. 2d 130 (1985), that publishers of certain financial newsletters were not "investment advisers." Id. at 211; see 15 U.S.C. § 80b-2(11)(D). After an extensive discussion of the legislative history of the Advisers Act, the Court held that existence of an advisory relationship depended largely on the character of the advice rendered. Persons engaged in the investment advisory profession "provide personalized advice attuned to a client's concerns." Lowe, 472 U.S. at 208. "[F]iduciary, person-to-person relationships" were "characteristic" of the "investment adviser-client relationship[]." Id. at 210. The Court thought it "significant" that the Advisers Act "repeatedly" referred to "clients," which signified to the Court "the kind of fiduciary relationship the Act was designed to regulate." Id. at 208 n.54, 201 n.45. This type of direct relationship existed between the adviser and the fund, but not between the adviser and the investors in the fund. The adviser was concerned with the fund's performance, not with each investor's financial condition.

The court stated that the Commission nevertheless was right to point out that the Lowe Court was not rendering an interpretation of the word "client." See Hedge Fund Rule, 69 Fed. Reg. at 72,069 n.174. Because it was construing an exception to the definition of "investment adviser," the court in this case did not read too much into the Court's understanding of the meaning of "client." See Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 162 L. Ed. 2d 820, 125 S. Ct. 2688, 2700 (2005).

The court stated that as it noted before, "[i]t may be that . . . the strict dichotomy between clarity and ambiguity is artificial, that what we have is a continuum, a probability of meaning." PDK I, 362 F.3d at 797. In this case, the court stated that even if the Advisers Act did not foreclose the Commission's interpretation, the interpretation fell outside the bounds of reasonableness. "An agency construction of a statute cannot survive judicial review if a contested regulation reflects an action that exceeds the agency's authority. It does not matter whether the unlawful action arises because the disputed regulation defies the plain language of a statute or because the agency's construction is utterly unreasonable and thus impermissible." Aid Ass'n for Lutherans v. United States Postal Serv., 355 U.S. App. D.C. 221, 321 F.3d 1166, 1174 (D.C. Cir. 2003); see also id. at 1177-78; Am. Library Ass'n v. FCC, 365 U.S. App. D.C. 353, 406 F.3d 689, 699 (D.C. Cir. 2005).

The court stated that "the 'reasonableness' of an agency's construction depends," in part, "on the construction's 'fit' with the statutory language, as well as its conformity to statutory purposes." Abbott Labs. v. Young, 287 U.S. App. D.C. 190, 920 F.2d 984, 988 (D.C. Cir. 1990). As described above, the Commission's interpretation of the word "client" came close to violating the plain language of the statute. At best it was counterintuitive to characterize the investors in a hedge fund as the "clients" of the adviser. See Am. Bar Ass'n v. FTC,c 368 U.S. App. D.C. 368, 430 F.3d 457, 471 (D.C. Cir. 2005). The adviser owed fiduciary duties only to the fund, not to the fund's investors. Section 206 of the Advisers Act, 15 U.S.C. § 80b-6, made it unlawful for any investment adviser -- registered or not -- "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Id. § 80b-6(2). In SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 84 S. Ct. 275, 11 L. Ed. 2d 237 (1963), the Supreme Court held that this provision created a fiduciary duty of loyalty between an adviser and his client. See id. at 191-92; id. at 201 ("The statute, in recognition of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested."); see also Hedge Fund Rule, 69 Fed. Reg. at 72,059 & n.57. In that case, the duty of loyalty required an adviser to disclose self-interested transactions to his clients. The Commission recognized more generally that the duty of loyalty "requires advisers to manage their clients' portfolios in the best interest of clients," and imposes obligations to "fully disclose any material conflicts the adviser has with its clients, to seek best execution for client transactions, and to have a reasonable basis for client recommendations." Id. at 72,054.

The court stated that if the investors are owed a fiduciary duty and the 451 F.3d 873, *880; 371 U.S. App. D.C. 358, **365; 2006 U.S. App. LEXIS 15760, ***20; Fed. Sec. L. Rep. (CCH) P93,890 entity was also owed a fiduciary duty, then the adviser would inevitably face conflicts of interest. The court stated, consider an investment adviser to a hedge fund that was about to go bankrupt, his advice to the fund would 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, the court in this case did not deem the shareholders in a corporation the "clients" of the corporation's lawyers or accountants. See RESTATEMENT, supra, § 96 cmt. b ("By representing the organization, a lawyer does not thereby also form a client-lawyer relationship with all or any individuals . . . who have an ownership or other beneficial interest in it, such as its shareholders."). While the shareholders could benefit from the professionals' counsel indirectly, their individual interests easily could be drawn into conflict with the interests of the entity. It simply could not be the case that investment advisers were the servants of two masters in this way.[33]

The court stated that the Commission's response to this argument was telling. It argued that the Hedge Fund Rule amended only the method for counting clients under § 203(b)(3), and that it did not "alter the duties or obligations owed by an investment adviser to its clients." 69 Fed. Reg. at 72,070. The court stated that it ordinarily presumes that the same words used in different parts of a statute have the same meaning. See Sullivan v. Stroop, 496 U.S. 478, 484, 110 S. Ct. 2499, 110 L. Ed. 2d 438 (1990). The Commission could not explain why "client" should mean one thing when determining to whom fiduciary duties were owed, 15 U.S.C. § 80b-6(1)-(3), and something else entirely when determining whether an investment adviser was required to register under the Act, id. § 80b-3(b)(3). Cf. Mobil Oil Corp. v. EPA, 276 U.S. App. D.C. 352, 871 F.2d 149, 153 (D.C. Cir. 1989).

The court stated that the Commission also argued that the organizational form of most hedge funds was merely "legal artifice," Br. for Resp. 41, to shield advisers who wanted to advise more than fifteen clients and remain exempt from registration. See Hedge Fund Rule, 69 Fed. Reg. at 72,068. But as the discussion above showed, form matters in this area of the law because it dictated to whom fiduciary duties were owed.

The court stated that the Hedge Fund Rule could be more understandable if, over the years, the advisory relationship between hedge fund advisers and investors had changed. The

[33] In the Hedge Fund Rule, 69 Fed. Reg. at 72,070 n.187, and again at oral argument, Tr. Of Oral Argument 16-17, the Commission argued that the fiduciary duties created by the anti-fraud provisions of the Advisers Act did in fact extend to the relationship between an adviser and the limited partners of a hedge fund. The Commission relied on Abrahamson v. Fleschner, in which the Second Circuit found that limited partners of a hedge fund stated a cause of action against the general partner for fraud under § 206. 568 F.2d at 877-78. The anti-fraud provision also applied, however, to persons other than clients. See 15 U.S.C. § 80b-6(4). In the absence of further specification, Abrahamson could only be read for the proposition that investors in a hedge fund may sustain an action for fraud against the fund's adviser. Cf. United States v. Elliott, 62 F.3d 1304, 1311-13 (11th Cir. 1995) (holding that adviser-client relationship was not required for criminal fraud conviction under § 206).

Commission cited, as justification for its rule, a rise in the amount of hedge fund assets, indications that more pension funds and other institutions were investing in hedge funds, and an increase in fraud actions involving hedge funds. The court stated that while all of this could be true, the dissenting Commissioners doubted it. But without any evidence that the role of fund advisers with respect to investors had undergone a transformation, there was a disconnect between the factors the Commission cited and the rule it promulgated. That the Commission wanted a hook on which to hang more comprehensive regulation of hedge funds could be understandable. But the Commission may not accomplish its objective by a manipulation of meaning.

The Commission had, in short, not adequately explained how the relationship between hedge fund investors and advisers justified treating the former as clients of the latter. See Shays v. FEC, 367 U.S. App. D.C. 185, 414 F.3d 76, 96-97 (D.C. Cir. 2005) (explaining that agency interpretation is not "reasonable" if it is "arbitrary and capricious"). The Commission pointed to its finding that a hedge fund adviser sometimes "may not treat all of its hedge fund investors the same." Hedge Fund Rule, 69 Fed. Reg. at 72,069-70 (citing different lock-up periods, greater access to information, lower fees, and "side pocket" arrangements). From this the Commission concluded that each account of a hedge fund investor "may bear many of the characteristics of 451 F.3d 873, *881; 371 U.S. App. D.C. 358, **366; 2006 U.S. App. LEXIS 15760, ***24; Fed. Sec. L. Rep. (CCH) P93,890 separate investment accounts, which, of course, must be counted as separate clients." Id. at 72,070. But the Commission's conclusion did not follow from its premise. It could be that different classes of investors had different rights or privileges with respect to their investments.[34] This revealed little, however, about the relationship between the investor and the adviser. Even if it did, the Commission had not justified treating all investors in hedge funds as clients for the purpose of the rule. If there were certain characteristics present in some investor-adviser relationships that marked a "client" relationship, then the Commission should have identified those characteristics and tailored its rule accordingly.

The court stated that, by painting with such a broad brush, the Commission had failed adequately to justify departing from its own prior interpretation of § 203(b)(3). See Mich. Pub. Power Agency v. FERC, 365 U.S. App. D.C. 313, 405 F.3d 8, 12 (D.C. Cir. 2005) (citing Greater Boston Television Corp. v. FCC, 143 U.S. App. D.C. 383, 444 F.2d 841, 852 (D.C. Cir. 1970)). The court stated that as it discussed, in 1985 the Commission adopted a "safe harbor" for general partners of limited partnerships, enabling them to count the partnership as a single "client" for the purposes of § 203 so long as they provided advice to a "collective investment vehicle" based on the investment objectives of the limited partners as a group. Safe Harbor Proposed Rule, 50 Fed. Reg. at 8741. This "safe harbor" remained part of the Commission's rules and had since been expanded to include corporations, limited liability companies, and business trusts (hedge funds sometimes take these less common forms, see Staff Report, supra, at 9-10 & n.27). The Hedge Fund Rule therefore appeared to carve out an exception from this safe harbor solely for investment entities that had fewer than one hundred-one but more than fourteen investors. Compare 17 C.F.R. § 275.203(b)(3)-1, with id. § 275.203(b)(3)-2. The Commission did not justify this exception by reference to any change in the nature of investment adviser-client relationships since the safe harbor was adopted. Absent such a justification, its choice

[34] This was in fact a common arrangement throughout the law of business organizations. Many corporations, for example, had different classes of common or preferred stock. Although different classes of stockholders had different rights or privileges, the basic fiduciary duties of managers to shareholders remained uniform.

appeared completely arbitrary. See Northpoint Technology, Ltd. v. FCC, 366 U.S. App. D.C. 363, 412 F.3d 145, 156 (D.C. Cir. 2005) ("A statutory interpretation . . . that results from an unexplained departure from prior [agency] policy and practice is not a reasonable one.").

The court stated that this choice was not any more rational when viewed in light of the policy goals underlying the Advisers Act. See Abbott Labs., 920 F.2d at 988. The Commission recited Congress's findings in § 201 that investment advisory activities "substantially . . . affect . . . national securities exchanges . . . and the national economy," 15 U.S.C. § 80b-1(3), and concludes that "[i]n enacting [section 203(b)(3)], Congress exempted from the registration requirements a category of advisers whose activities were not sufficiently large or national in scope." Hedge Fund Rule, 69 Fed. Reg. at 72,067. The Commission reasoned that because hedge funds were national in scope, treating the entity as a single client for the purpose of the exemption would frustrate Congress's policy. The court stated that if Congress did intend the exemption to prevent regulation only of small-scale operations -- a policy goal that was clear from neither the statute's text nor its legislative history – the Commission's rule had no rational relationship to achieving that goal. The number of investors in a hedge fund -- the "clients" according to the Commission's rule -- revealed nothing about the scale or scope of the fund's activities. It was the volume of assets under management or the extent of indebtedness of a hedge fund or other such financial metrics that determined a fund's importance to national markets. One might say that if 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. But the Hedge Fund Rule only exacerbated whatever problems one might perceive in Congress's method for determining who to regulate. The Commission's rule created a situation in which funds with one hundred or fewer investors are exempt from the more demanding Investment Company Act, but those with fifteen or more investors trigger registration under the Advisers Act. The court found that this was an arbitrary rule.

IX. Conclusion

The Goldstein case suggests that regulation of hedge funds and private equity funds by the SEC may be difficult; however, regulation of such funds may be imposed by the Department of Labor with respect to investments made by pension funds pursuant to the fiduciary responsibility rules under Part 4 of Title I of ERISA. Hedge funds and private equity funds could be required to provide more disclosure of their investments and be required to register under the Investment Advisers Act of 1940 in order to invest assets of a pension plan under ERISA. Other steps could also be taken consistent with the earlier suggestions in making such funds a safer investment.