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One Step Forward for Hedge Fund Investors: The Removal of the Solicitation Ban and the Challenges That Lie Ahead,

Cary Martin Shelby, *DePaul University*

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ONE STEP FORWARD FOR HEDGE FUND INVESTORS: THE REMOVAL OF THE SOLICITATION BAN AND THE CHALLENGES THAT LIE AHEAD

Cary Martin[†]

The JOBS Act accomplished what many thought to be inconceivable. After being excluded from the privilege of advertising for eight decades, Congress has finally lifted the solicitation ban for emerging companies, hedge funds, and various other private vehicles. With respect to the hedge fund industry, which is the primary focus of this article, there have been numerous discussions among commentators regarding the anticipated effects of this law. These discussions range from measuring the extent to which the JOBS Act will facilitate capital formation, to whether it will undermine this goal by leading to an influx of fraudulent investment schemes. In contrast, this Article focuses on the anticipated effects that advertising will have on hedge fund investors, which can include wealthy individuals, pension plans, insurance companies, banks, and various other classes of institutions. This Article argues that advertising could actually enhance investor protection for this subset of investors as it will likely improve transparency, promote healthy competition, and, in some cases, make it more difficult for fraudulent advisers to induce prospective investors. And while the removal of the solicitation ban is generally a step in the right direction for hedge fund investors, this Article concludes with a brief discussion of the regulatory challenges that still remain and an explanation of why these hurdles may be exacerbated with the removal of the ban. Such challenges include the inherent conflicts of interest and the

[†] Assistant Professor, DePaul University College of Law; William H. Hastie Fellow, University of Wisconsin Law School (May 2012); J.D., Northwestern University School of Law (May 2006). I would like to extend special thanks to Irtaza Asif for his ongoing support and assistance as my invaluable research assistant. I would also like to thank participants from the following conferences: The Re-Education of Barack Obama, Midwest People of Color Conference; Power, Privilege and the Pursuit of Justice: Legal Challenges in Precarious Times, Law and Society Association 2013 Annual Meeting; and the 2013 Junior Faculty Workshop on Financial Services Law at University of Connecticut School of Law. Of course, all errors are my own.

lack of standardization with respect to hedge fund valuations, the fraud loophole created by smaller funds that escape oversight under the Advisers Act, and the potential increase in speculation that could significantly compromise investor confidence.

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INTRODUCTION

“Together, we discovered that a free market only thrives
when there are rules to ensure competition and fair play.”¹

President Barack Obama

The Jumpstart Our Business Startups Act (the “JOBS Act”) is a monumental piece of legislation that was enacted under the Obama Administration on April 5, 2012.² Its purported purpose is “[t]o increase American job creation and economic growth by improving access to the

1. President Barack Obama, Inaugural Address at United States Capitol (Jan. 21, 2013) (transcript available at <http://www.whitehouse.gov/the-press-office/2013/01/21/inaugural-address-president-barack-obama>).

2. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

public capital markets for emerging growth companies.”³ The JOBS Act seeks to achieve these goals by relaxing many of the regulations that previously applied to private issuers.⁴ Thus, the fundamental assumption that underscores this legislation is that looser regulations can make it easier for private companies to raise capital, which will in turn fuel growth within the broader economy.

One of the most prominent components of the JOBS Act is its elimination of the solicitation ban for private companies that rely on Rule 506 of Regulation D.⁵ Under this exemption, private issuers were allowed to raise an unlimited amount of capital and offer interests to an unlimited number of accredited investors.⁶ In exchange, however, such issuers were largely restricted from advertising to the general public so as to preserve the private nature of these vehicles.⁷ This exclusion encompassed a wide range of both direct and indirect communications between private issuers and prospective investors.⁸ For example, a private issuer could lose its Rule 506 exemption by communicating any aspect of its underlying business to the press, mentioning a fund name in an interview, or maintaining informative websites regarding its offerings or investment strategies.⁹ As a result of this broad interpretation, many issuers, particularly smaller and emerging companies, faced significant hurdles in entering private markets.¹⁰ With the removal of the solicitation ban, these companies are now permitted to engage in broad advertising activities to actively solicit a wider range of prospective investors, which will arguably make it easier for such issuers to access the private markets on a level playing field with larger issuers.¹¹

With respect to the hedge fund industry, which is the primary focus of this article, there have been many discussions among commentators regarding the anticipated effects of this new law. These discussions range

3. *Id.*

4. *Id.*

5. Pub. L. No. 112-106, §201(a), 126 Stat. 306, 313 (2012).

6. 17 C.F.R. § 230.506 (2013).

7. 17 C.F.R. §§ 230.502(c), .506 (2013).

8. 17 C.F.R. § 230.502(c) (2013).

9. See discussion *infra* Part II.A (explaining the previous legal framework of regulating informative solicitation).

10. See, e.g., William K. Sjostrom Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 4 (2004) (asserting “that the ban [had] a negative impact on the capital-raising efforts of emerging companies”); Stuart R. Cohn, *Securities Markets for Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions*, 28 U. FLA. L. REV. 1, 7 (1986) (arguing that “[s]mall, developing companies are severely handicapped by the non-solicitation rules”).

11. Sjostrom, *supra* note 10, at 4.

from measuring the extent to which the JOBS Act will facilitate capital formation,¹² to determining whether it will undermine this goal by leading to an influx of fraudulent investment schemes.¹³ As background, hedge funds are privately organized investment companies that utilize a broad array of strategies.¹⁴ Contrary to their mutual fund counterparts, hedge funds have more flexibility to engage in derivatives trading and maintain higher levels of leverage.¹⁵ They also retain several other flexibilities related to disclosure practices, governance structures, and accounting requirements, which are all tightly regulated processes for registered investment companies.¹⁶ Since hedge funds are restricted to accredited investors,¹⁷ such as wealthy individuals, pension plans, insurance companies, banks, and other categories of institutions, they are generally

12. See, e.g., American Bar Association: Business Law Section, Comment Letter Relating to Section 201 of JOBS Act (April 20, 2012), <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-7.pdf> (discussing how removal of the solicitation ban is a cost-effective mechanism to increase capital formation); *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearings Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 7 (2011) (statement of John C. Coffee, Adolf A. Berle Professor of Law, Columbia University Law School) (claiming that the removal of the ban “will simplify private placements and allow smaller issuers to reach more investors at low cost”); BlackRock, Inc., Comment Letter Relating to Section 201 of JOBS Act (May 3, 2012), <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-10.pdf>, [hereinafter BlackRock Letter] (explaining why the solicitation ban was too restrictive); Hedge Fund Ass’n Ltd., Comment Letter Relating to Section 201 of JOBS Act (June 6, 2012), <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-22.pdf> (asserting that removal of the solicitation ban is “fundamental to the continued growth of the hedge fund industry and that allowing general solicitations to further that outcome will encourage emerging managers to continue to enter the industry.”).

13. See, e.g., Fund Democracy, Inc. et al., Comment Letter Relating to Section 201 of JOBS Act (May 24, 2012), <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-14.pdf> (suggesting that the removal of the ban will lead to an increase in fraudulent conduct); William F. Galvin, Sec’y of the Commonwealth, Commonwealth of Mass., Comment Letter Relating to Section 201 of JOBS Act (July 2, 2012), <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-37.pdf> (discussing the possibility of Rule 506 offerings becoming the new “Wild West” for fraudulent advisers to induce prospective investors); Andrea L. Seidt, Comm’r, Ohio Div. of Sec., Comment Letter Relating to Section 201 of JOBS Act (July 3, 2012), <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-38.pdf> (stating that “[a]ccredited investors present prime, well-funded targets to scam artists who will not hesitate to take advantage of the new general solicitation and general advertising freedoms to troll for victims.”).

14. U.S. SEC. & EXCH. COMM’N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, 33–34 (2003), <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [hereinafter SEC STAFF REPORT].

15. *Id.*

16. See generally *The Differences Between Mutual Funds and Hedge Funds*, INV. CO. INST. (Apr. 2007), http://www.ici.org/investor_ed/brochures/faqs_hedge (laying out the differences between the two investment vehicles).

17. See 17 C.F.R. § 230.501(a) (2012) (defining “accredited investor”).

exempt from the arduous registration requirements that typically apply to mutual funds.¹⁸ As opposed to focusing on the direct impact to issuers and/or the inducement of fraudulent issuers, this Article focuses on the extent to which advertising could actually improve protection for this subset of investors.

Generally, our federal securities laws strive to enhance investor protection by: (1) providing investors with more information and greater transparency to make better investment decisions; (2) providing regulators with more information and greater efficiency to better detect investment fraud; and (3) deterring investment advisers from participating in fraudulent investment activities. Although the very nature of the JOBS Act is to loosen regulations that apply to private companies, permitting general solicitations can actually support these fundamental goals of investor protection frameworks. More specifically, this Article argues that advertising could enhance investor protection for this subset of investors as it will likely improve transparency, promote healthy competition, and in some cases, make it more difficult for fraudulent advisers to induce prospective investors.

As to improving transparency, this Article highlights how the solicitation ban contributed to the general opaqueness that historically shrouded the industry.¹⁹ Under the previous restrictions, since the definition of solicitation was extremely broad, hedge fund advisers were severely restricted from communicating any meaningful information about their funds in a broad medium.²⁰ For example, an accredited investor who was interested in learning more about the industry encountered difficulties in accessing detailed information from a large range of hedge funds.²¹ Going forward, hedge funds will probably publish more informative websites, engage in greater communications at industry events, and share more business-related information to the press.²² In effect, enhancing the flow of information will give hedge fund investors more tools to optimize their investment decisions and will also help researchers and regulators to more clearly define the hazards presented by the exponential growth of these private vehicles.²³

With respect to improving competition, this Article argues that the removal of the solicitation ban will promote healthy competition within the

18. See *supra* note 16 and accompanying text (referencing the differences between mutual funds and hedge funds).

19. See discussion *infra* Part II.B.

20. See discussion *infra* Part II.A.

21. See discussion *infra* Part II.A.

22. See discussion *infra* Part II.C.

23. See discussion *infra* Part II.C.

industry.²⁴ Because of the numerous benefits that typically result from the sustainment of competitive markets, several legal frameworks, both in the United States and abroad, will serve to protect markets from monopolistic forces.²⁵ For example, removing the solicitation ban will make it easier for emerging hedge funds to effectively compete with their larger, more-established counterparts, which could in turn foster innovation.²⁶ Increasing competition may also create more clearly defined industry norms and standards, which could lead to proliferation of higher quality products within the industry.²⁷ Overall, this increased competition will eventually help to optimize investor choice, facilitate innovation, and encourage investment in higher quality products.

This Article further argues that the removal of the solicitation ban can actually deter fraud in certain respects.²⁸ Having to operate in a more transparent marketplace, where higher quality products are heavily promoted and marketed, will make it more difficult for fraudulent advisers to dupe unsuspecting investors.²⁹ The removal of the solicitation ban may also loosen the reliance on trusted referrals, which assisted in the perpetuation of the Madoff scandal and other comparable Ponzi schemes.³⁰ Moreover, since advisers are now required to notify the SEC of their intentions to advertise on their Form D filings, they will be less likely to effectuate their schemes through false advertising.³¹ The existing federal securities laws, particularly the Investment Advisers Act of 1940 (the “Advisers Act”), also serve as additional layers of protection.³² These existing frameworks heavily regulate performance presentations, testimonials, and any other material information that would appear on an investor communication.³³

Although the removal of the solicitation ban is generally a step in the right direction for hedge fund investors, future regulatory challenges still remain.³⁴ These challenges include the inherent conflicts of interest and the lack of standardization in hedge fund valuations, the fraud loophole created by smaller funds that escape oversight under the Advisers Act, and the potential increase in speculation that could significantly compromise

24. See discussion *infra* Part II.

25. See discussion *infra* Part III.A.

26. See discussion *infra* Part III.B.

27. See discussion *infra* Part III.C.

28. See discussion *infra* Part IV.

29. See discussion *infra* Part IV.A.

30. See discussion *infra* Part IV.A.

31. See discussion *infra* Part IV.B.

32. See discussion *infra* Part IV.C.

33. *Id.*

34. See discussion *infra* Part V.

investor confidence.³⁵ For instance, two different advertisements for competing hedge funds, each trading the same illiquid securities, equally promote an annual return of 10%. However, since hedge funds are not subject to standardized valuation mechanisms, it is difficult for investors to adequately compare such figures with certainty.³⁶ In addition, smaller advisers escape federal oversight under the Advisers Act, even though various studies have shown that they are frequently more susceptible to fraud. Thus, requiring Advisers Act registration for all advisers who utilize general solicitations may be the most viable solution to address this loophole. Also, the increasing growth of the industry could lead to an increase in speculation within the broader capital markets.³⁷ This could significantly compromise investor confidence, causing liquidity problems and valuation discrepancies in the long-run.³⁸

The valuation challenges can be resolved through future regulatory actions that would require third-party oversight of the specific calculations and/or mandating standardized calculations for particular hedge fund investments.³⁹ It is too early to determine whether there is a significant correlation between advertising and speculation. Even if speculation does increase within the broader capital markets, it is equally difficult to measure the resulting harm, if any, to investor confidence and capital production. Due to this uncertainty, the SEC and/or Congress should mandate the completion of a study by the SEC's Division of Economic and Risk Analysis, which would rigorously investigate the resulting speculation that is created by the ever-growing hedge fund industry.⁴⁰ This study should be completed within two years after the final solicitation rules are adopted by the SEC.

In summary, Part II briefly highlights the previous legal framework that broadly prohibited general advertisements and explains how this restriction was likely over-inclusive. Part III then illustrates how the removal of the solicitation ban can fuel healthy competition within the industry, which can optimize investor choice, lead to greater innovation, and promote higher quality products. Part IV discusses the extent to which the removal of the solicitation ban can actually deter fraud — the resulting increase in competition will make it more difficult for fraudulent advisers to solicit prospective investors. It then explains how both the new and existing regulatory frameworks will serve as additional layers of protection

35. See discussion *infra* Part V.A.

36. See discussion *infra* Part V.A.

37. See discussion *infra* Part V.B.

38. See discussion *infra* Part V.B.

39. See discussion *infra* Part V.A(iii).

40. See discussion *infra* Part V.B.

from fraudulent communications. Part V briefly identifies the remaining regulatory challenges that have not been sufficiently addressed, which include: conflicts of interest and the lack of standardization with respect to valuations, the fraud loophole created by smaller funds that escape oversight under the Advisers Act, and the potential increase in speculation that could significantly compromise investor confidence. Part V also suggests possible solutions to these regulatory challenges, some of which include third-party oversight over valuations and/or standardized methodologies for particular hedge fund investments. In addition, all advisers who utilize general solicitations should be required to register under the Advisers Act to ensure that all such investors are receiving comparable disclosures. A study should also be undertaken by the SEC to rigorously study the resulting increase in speculation.

I. TRANSPARENCY

Part I summarizes how lifting the advertising ban could enhance investor protection by increasing transparency related to prospective hedge fund investments. This part begins by briefly outlining the previous legal framework that broadly prohibited general advertisements. It continues by explaining how this restriction was likely over-inclusive, which led to various informational asymmetries between prospective investors and their potential hedge fund investments. Part I concludes by discussing the ways in which the new framework will likely improve transparency through more detailed websites, greater communications at industry events, and increased information sharing with industry related press. Enhancing the flow of information will help hedge fund investors to optimize their investment decisions and will also help researchers and regulators to more clearly define the hazards of the exponential growth of these private vehicles.

A. *Previous Framework*

For the most part, the federal securities laws are not intended to regulate transactions that are private in nature or where the “public benefits are too remote.”⁴¹ More specifically, under Section 4(a)(2) of the Securities Act of 1933 (the “Securities Act”), any transaction not involving a public offering is exempt from the arduous registration requirements of the federal securities laws.⁴² Since the statute does not provide a specific

41. COMM. ON INTERSTATE & FOREIGN COMMERCE, FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT SECURITIES IN INTERSTATE COMMERCE, H.R. REP. NO. 73-85, at 5 (1933).

42. Securities Act of 1933, 15 U.S.C. § 77d(2) (2006).

definition of the term “public,” issuers were historically reluctant in relying on this exemption, as an inadvertent public offering would result in a right of rescission for its underlying investors.⁴³ In response, the SEC, as well as the Supreme Court, provided additional guidance for interpreting this pivotal term through a series of releases and opinions.⁴⁴

In 1982, in an effort to provide even greater certainty for issuers relying on this exemption, the SEC promulgated three safe harbors commonly referred to as Rules 504, 505, and 506 under Regulation D.⁴⁵ These rules sought to provide issuers with bright-line standards for determining whether companies were legitimately operating as private vehicles.⁴⁶ Exempt investment companies such as venture capital funds, private equity funds, and hedge funds frequently select Rule 506, since it allows them to raise an unlimited amount of capital from an unlimited number of accredited investors.⁴⁷ In exchange however, vehicles relying on Rule 506 were prohibited from advertising their exempt offerings to the general public, so as to preserve the private nature of these entities, and perhaps to restrict the size of the industry.⁴⁸

While Regulation D does not provide a specific definition of the terms “general advertising” or “general solicitation,”⁴⁹ Rule 502(c) provides a list of examples of the kinds of communications that could constitute a solicitation to the general public.⁵⁰ Under this rule, general solicitations can include “[a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio”⁵¹ and “any seminar or meeting whose attendees have

43. If an issuer mistakenly relies on a 4(a)(2) exemption, then such issuer has essentially sold unregistered securities in violation of Section 5 of the Securities Act. *See id.* § 77e (stating that non-exempt unregistered securities are unlawful). Thus, an issuer in this scenario would face liability under Section 12(a)(1) of the Securities Act, which generally grants investors a right of rescission. *Id.* § 77l(a)(2).

44. Cary Martin, *Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investor Exemption*, 37 DEL. J. CORP. L. 50, 65–67 (2012) (describing the evolution of the sophisticated investor doctrine, which presumes that certain wealthy and institutional investors can adequately fend for themselves).

45. *See* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6,389, 24 SEC Docket 1166 (Mar. 8, 1982) (debuting the uniform notice of sales to be used for all offerings).

46. *Id.*; *see also* 17 C.F.R. §§ 230.504–506 (2011) (providing conditions for fulfilling private placement exemption).

47. 17 C.F.R. § 230.506 (2013).

48. *Id.*; 17 C.F.R. § 230.502(c) (2013).

49. The terms “solicitation” and “advertisement” (and any related variations) are used interchangeably throughout this Article.

50. 17 C.F.R. § 230.502(c).

51. *Id.* § 230.502(c)(1).

been invited by any general solicitation or general advertising.”⁵² Nevertheless, other categories of communications, not specifically listed in Rule 502(c) or addressed in an SEC no-action letter or enforcement action, could still be considered unlawful.⁵³ The SEC has consistently reiterated that Rule 502(c) inquiries depend on the unique facts and circumstances of each particular case. Thus, determining whether a particular communication runs afoul of 502(c) is uncertain and unpredictable.

Given this broad restriction on communications with prospective investors, issuers relying on Rule 506 were only allowed to solicit investors with whom they had a sufficient preexisting relationship.⁵⁴ Such preexisting relationships are deemed sufficient only if the nature of the relationship enables the issuer (or person acting on its behalf) to be aware of the financial circumstances or sophistication of the person with whom the relationship exists.⁵⁵ The issuer must also acquire this relationship before the terms of the offering are created and before the contemplated offering begins.⁵⁶ As a result, hedge funds would often restrict marketing activities to personal or close networks of potential investors with whom they already had a relationship.⁵⁷

If an issuer did not have access to these kinds of preexisting relationships with accredited investors, it could simply contract for such access from registered financial intermediaries, such as brokers or placement agents.⁵⁸ When utilizing this option, “funds . . . enter into formal placement arrangements with major investment firms such as Morgan Stanley, Merrill Lynch, and the like. These firms are typically compensated through a placement fee or sales charge”⁵⁹ This practice has been deemed legally sound by the SEC as these intermediaries are

52. *Id.* § 230.502(c)(2).

53. *See id.* § 230.502(c) (stating that the provided examples of general solicitations are nonexclusive).

54. Kenman Corp., Exchange Act Release No. 21962, 1985 WL 548507 (April 19, 1985).

55. Mineral Lands Research & Mktg. Corp., SEC No-Action Letter, 1985 WL 55680 (Dec. 4, 1985).

56. *Id.*

57. *See Impact of “Private Fund” Advertising*, DARIEN CAPITAL SERVICES BLOG (July 16, 2013), <http://blog.dariancs.com/2013/07/16/impact-of-private-fund-advertising/> (describing the “prevalence of ‘business card’ type websites” due to the limited information that hedge funds could provide the public prior to the JOBS Act).

58. *See* E.F. Hutton & Co., Inc., SEC No-Action Letter, 1985 WL 55680 (Dec. 3, 1985) (authorizing use of suitability questionnaires for creating substantive relationships for offering purposes); *see also* Bateman Eichler, Hill Richards, Inc., SEC No-Action Letter, 1985 WL 55679 (Dec. 3, 1985) (sanctioning the use of questionnaires sent to a limited number of local businesspeople by the broker-dealer’s account executives).

59. Ethan W. Johnson, *Hedge Fund Marketing Overview*, 7 J. INV. COMPLIANCE 48, 48 (2006), available at http://www.morganlewis.com/pubs/Johnson_HedgeFundMrketing.pdf.

simply soliciting investors who have a general interest in investing in private placements.⁶⁰ These solicitations often take the form of online suitability questionnaires, which are designed to determine whether a prospective investor qualifies as accredited under Rule 501.⁶¹ However, the suitability questionnaire (or solicitation) may not mention any particular private placement offering and must occur prior to any contemplated offering of an issuer.⁶²

B. Solicitation Ban Likely Over-Inclusive

The deliberate uncertainty regarding the definition of “general solicitation” has made it difficult for advisers to predict whether a communication would run afoul of Regulation D. As previously discussed, if a hedge fund adviser relied on incorrect legal analysis and inadvertently made a communication later deemed unlawful under 502(c), such adviser would have faced dire legal consequences.⁶³ Under this scenario, the hedge fund adviser would likely have lost its Regulation D exemption and face rescission of all of its previously sold interests.⁶⁴ As a result, the application of this ban had become over-inclusive since hedge funds were restricted from communicating meaningful information to prospective investors.

For example, direct communications made between accredited investors and prospective hedge fund advisers were severely limited. Even if a communication by a hedge fund adviser was directed exclusively to accredited investors (with whom the adviser had no preexisting relationship), it would still run afoul of 502(c).⁶⁵ Similarly, any information that a hedge fund adviser shared with accredited investors at seminars, meetings, or trade events regarding its underlying fund(s) also subjected the adviser to liability under the Securities Act.⁶⁶ To the extent

60. See *supra* note 58 and accompanying text (giving examples of permissible practices using broker-dealers).

61. See IPONET, SEC No-Action Letter, 1996 WL 431821 (July 26, 1996) (permitting use of electronic coupons or cards to indicate interest in an offering).

62. *Id.*

63. See *supra* note 43 and accompanying text (describing the consequences of mistaken reliance on Section 4(a)(2)).

64. See *supra* note 43 and accompanying text (stating that liability for violation may include rescission).

65. See Interpretive Release on Regulation D, Securities Act Release No. 6455, 27 SEC Docket 347, 360 (Mar. 3, 1983) (“The mere fact that a solicitation is directed only to accredited investors will not mean that the solicitation is in compliance with Rule 502(c).”).

66. See, e.g., Gerald Klein & Assocs., Inc., Securities Act Release No. 8585, Investment Company Act Release No. 26,986, 2005 WL 1615435 (July 8, 2005) (reporting that where hedge funds were organized in violation of the Securities Act, and not exempted

that accredited investors attended an industry event to learn more about specific hedge fund investments, the advertising restriction curtailed such investors from gaining detailed information directly from advisers. Furthermore, the restricted communications were not limited to information regarding an upcoming offering. Rather, any information regarding fundraising events, upcoming financial changes, or anything else pertaining to the issuer's business could "be construed as implied offers or as efforts to prime the market"⁶⁷ Also, responding to unsolicited requests for information about a hedge fund could also run afoul of solicitation ban. For instance, Phillip Goldstein, the hedge fund manager of Bulldog Investments, was subjected to an enforcement action by the Commonwealth of Massachusetts because he responded to an e-mail request from an investor who requested specific information about his fund.⁶⁸ As a result, lawyers generally advise their hedge fund clients to develop scripted responses for unsolicited requests for information. An example of such response is as follows: "This is a private placement only for qualified purchasers who are personally known to us or to our placement agent. We do not send our private placement memorandum in response to unsolicited inquiries. Thank you for your interest in us."⁶⁹ In order for an investor to gain access to specific information regarding a hedge fund, the investor must first establish a relationship with either the adviser or a qualified placement agent before the contemplated offering begins.

Communications made through electronic media could also constitute an unlawful communication under 502(c). The SEC further provided that the use of any unrestricted website constitutes an unlawful general solicitation.⁷⁰ Thus, hedge fund websites are generally password-protected

therefrom, the investment advisers responsible for their organization are liable too); Brian Prendergast, Exchange Act Release No. 44,632, 2001 WL 872693 (Aug. 1, 2001) (holding securities broker in violation of Exchange Act due to improper solicitation through a private placement memorandum for a hedge fund).

67. *Private Offering Dos and Don'ts: Dealing with the Press and Avoiding a General Solicitation*, MORGAN, LEWIS & BOCKIUS LLP (2013), at 3, http://www.morganlewis.com/documents/VCPEFdeskbook/VCPEFdeskbook_PrivateOfferingDosAndDonts.pdf; see also REMCO Sec. Co., Inc., SEC No-Action Letter, 1985 WL 55621 (July 22, 1985) (finding that press releases describing successful completion of oil wells and other notable business events would constitute an unlawful general solicitation).

68. Jeff Benjamin, *What's So Bad About Hedge Fund Advertising, Anyway?*, INV. NEWS (July 12, 2013, 3:22PM), <http://www.investmentnews.com/article/20130712/BLOG12/130719965> (depicting Goldstein's legal troubles despite the solicitee not investing in his hedge fund).

69. *Private Offerings Dos & Don'ts*, *supra* note 67, at 3.

70. See Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, 60 SEC Docket 1091, 1100 (Oct. 6, 1995) (prohibiting the placement of offering

so as to prevent access from the general public.⁷¹ Only pre-qualified accredited investors can actually access such websites.⁷² Due to this massive restriction, the websites published by hedge funds are typically meager and uninformative.⁷³ Jay Gould, a partner in the investment funds practice at Pillsbury Winthrop Shaw Pittman LLP, recently reiterated the challenges of interpreting the solicitation ban as it pertains to electronic media.⁷⁴ He stated, “[d]eciphering the boundaries of the ban has become increasingly difficult with the rise of the Internet and social media, which make available widely information about hedge funds Hedge-fund managers frequently grapple with whether any public statements, or even a company website, open them up to regulatory action.”⁷⁵

With respect to press releases and interviews, any published statement by a hedge fund adviser could also violate Section 502(c).⁷⁶ The broad reach of this restriction is aptly summarized in a comment letter published by the Managed Funds Association (the “MFA”), an industry group that represents a large fraction of the global alternative investment industry.⁷⁷ In this comment letter, Richard Baker, the President and CEO of the MFA, stated that “private fund managers generally will not respond to press inquiries, even to correct inaccurate reports that will be published and could potentially harm their firms.”⁷⁸ Furthermore, any announcement of

materials on a website even if access is restricted to individuals who properly answer the access question).

71. See Lamp Techs., Inc., SEC No-Action Letter, 1998 WL 278984 (May 29, 1998) (hereinafter Lamp Techs. 1998) (permitting the placement of offering materials on a website that is password-protected regardless of whether a subscription is purchased or a determination that the investors are “qualified eligible participants”); see also Lamp Techs., Inc., SEC No-Action letter, 1997 WL 282988 (May 29, 1997) (describing the process by which accredited investors pay a subscription fee to access a password-protected website to access private offerings).

72. Lamp Techs. 1998, *supra* note 71, at 1.

73. *Private Offerings Dos & Don'ts*, *supra* note 67, at 3.

74. Juliet Chung, *Jobs Bill Opens Door to Hedge Advertising*, WALL ST. J., Mar. 28, 2012, <http://blogs.wsj.com/deals/2012/03/28/jobs-bill-opens-door-to-hedge-advertising>.

75. *Id.*

76. See THOMAS P. LEMKE ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 4.8 (2013) (commenting that an interview may be construed as a solicitation if it referenced a private fund even if the intent was not to solicit).

77. The MFA is “an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry’s contributions to the global economy.” *About MFA*, MANAGED FUNDS ASS’N, <http://www.managedfunds.org/about-mfa> (last visited Apr. 9, 2014).

78. Richard Baker, President & CEO of Managed Fund Ass’n, Comment Letter regarding Petition for Rulemaking on Rule 502 of Regulation D (Jan. 9, 2012), <http://www.sec.gov/rules/petitions/2012/petn4-643.pdf> (making the argument that removing

upcoming business changes to the press, even if no particular offer is mentioned, could also violate the solicitation ban because the SEC had historically viewed these communications as implied offers or sales.⁷⁹ In addition, the mere act of an adviser (or adviser representative) mentioning a fund name in an interview could be viewed as an unlawful advertisement.⁸⁰ This strict outcome applies even if the adviser did not intend to advertise his/her fund at the time of the interview.⁸¹ To mitigate the harsh effects of the solicitation ban, lawyers frequently give hedge funds the following advice when responding to inquiries from the press: “[1] Avoid identifying by name any hedge fund or private fund . . .; [2] Avoid specific discussions of past performance . . . [3] Avoid mentioning specific securities positions . . .; and [4] Avoid mentioning any material, non-public information”⁸² Overall, lawyers advise hedge fund clients to communicate as little information as possible when dealing with any inquiries related to their funds.

C. *Lifting Advertising Ban Could Enhance Transparency*

Lifting the ban on advertising could enhance transparency within the entire industry, which could in turn enhance investor protection.⁸³ As discussed in Part II.B above, the restrictions on advertising implemented under Regulation D were likely over-inclusive as they chilled communications between hedge fund advisers and prospective investors. These sweeping communication restrictions have contributed to the general opacity and mystery that has historically shrouded the industry. The SEC even advocated for lifting the ban in its often-cited *Implications of the Growth of Hedge Funds* study, in which the SEC specifically recommended that the “[c]ommission consider eliminating the prohibition on general solicitation or advertising in offerings by hedge funds . . .” in an effort to improve transparency.⁸⁴ In effect, increased information about the hedge fund universe within the public sphere could serve as a vital tool for

the solicitation ban will improve transparency because it will give investors more access to information relating to prospective hedge fund investments).

79. LEMKE ET AL., *supra* note 76, § 4.8.

80. *Id.*

81. *Id.*

82. *Id.* §5.12.

83. See L. Gordon Crovitz, Op-Ed., *Transparency is More Powerful Than Regulation*, WALL ST. J., Mar. 30, 2009, at A21, available at <http://online.wsj.com/article/SB123837223623167841.html> (“Better transparency is the surest way to make markets more efficient and less volatile. Market wisdom results when more people access better information.”).

84. SEC STAFF REPORT, *supra* note 14, at xii.

prospective investors who are interested in learning more about the general characteristics of the business. Steven Nadel, a partner at Seward & Kissel LLP who specializes in hedge funds and alternative investments, similarly believes that:

“[t]he lift on the advertising ban will educate a broader group about the type of private offerings available ‘There’s plenty of wealthy Americans who may not be super sophisticated when it comes to investing in alternatives It will create more knowledge, more transparency, [and] more understanding of the entire alternative industry.’”⁸⁵

In fact, many commentators agree that lifting the solicitation ban could improve the public’s perception of the industry, which is typically characterized as being secretive, sinister, and deeply opaque.⁸⁶ To the extent that hedge funds are actively engaged in activities that actually improve the global economy, such as providing much needed liquidity to the markets, investing in distressed debt, or even participating in charitable causes, the removal of the solicitation ban can help to highlight these good deeds.⁸⁷ Hedge funds will no longer encounter stringent liabilities under the federal securities laws in highlighting their various strengths. With the removal of the solicitation ban, investors will have a more complete picture of the hedge fund universe.

Although it is difficult to predict with certainty the full extent to which hedge funds will utilize this new power to advertise, the marketing changes instituted by funds will likely be incremental. At the outset, hedge funds will probably create more informative websites that are publicly accessible, become more candid with the media regarding their business and risk

85. Jesse Hamilton & Margaret Collins, *Hedge Funds Cleared to Advertise Under SEC Proposal*, BLOOMBERG, Aug. 29, 2012, <http://www.bloomberg.com/news/2012-08-28/hedge-fund-marketing-could-begin-new-era-as-sec-set-for-proposal.html>.

86. See, e.g., Jenny Anderson, *Hedge Funds Walk a Hard Line Between Silence and Sharing*, N.Y. TIMES, Feb. 9, 2007, at C7 (reporting on the small group of hedge funds seeking permission to talk to the media about their funds on the record); John Lovallo, *JOBS Act; Hedge Fund Communications Options Poised to Expand*, JD SUPRA, (Dec. 7, 2012), <http://www.jdsupra.com/legalnews/jobs-act-hedge-fund-communications-opti-77250> (describing the heavy scrutiny inevitable in hedge fund marketing’s legalization); Marine Cole, *Hedge Funds Won’t Rush to Advertise Even After Ban Lifted: Largest Firms Most Likely to Test the Waters, But Restrictions Remain*, ADVERTISING AGE (July 12, 2013), <http://adage.com/article/news/hedge-funds-rush-advertise-ban-lifted/243047> (suggesting that smaller firms may lead the charge to try marketing).

87. Lovallo, *supra* note 86; see also Tom Hals, *Hedge Funds on the Hunt in Detroit*, REUTERS, May 8, 2013, available at <http://www.foxbusiness.com/news/2013/05/08/analysis-hedge-funds-in-search-distress-take-look-at-detroit> (discussing hedge funds’ exploration of buying distressed municipal debt of Detroit).

management practices, and “engage in more natural marketing with contacts made at venues like industry conferences.”⁸⁸ It is highly unlikely that hedge funds will pursue widely disseminated television campaigns or radio broadcasts.⁸⁹ Many hedge funds will simply avoid implementing massive advertising campaigns because they are still restricted to accredited investors.⁹⁰ As such, hedge funds do not have the need to market to broader audiences that would include large numbers of retail investors.

Moreover, the final rule adopted by the SEC puts a greater burden on advisers, who choose to utilize this new advertising power, to verify that prospective investors qualify as accredited. The SEC recommends that such a verification process “take into account the particular facts and circumstances surrounding each transaction, including the nature of the purchaser, the amount and type of information the purchaser has about the issuer, and the nature of the offering (including the manner in which the purchaser was solicited).”⁹¹ Previously, hedge funds could simply rely on investors to “check-the-box” next to written accredited investor representations on subscription agreements and other investor contracts. Tower Fund Manager, a prominent hedge fund administrator, predicts that this heightened verification process will cause increased regulatory

“scrutiny . . . in proportion to the magnitude of the marketing campaign run by the fund manager. Providing information about fund strategy and returns on websites or speaking on panels at industry events; less scrutiny. Sponsoring a blimp during the Super Bowl; a knock on the door at half time could upstage any wardrobe malfunction.”⁹²

88. Nathan J. Greene, *SEC JOBS Act Rulemaking Creates Opportunities and Potential Burdens for Hedge Funds Contemplating General Solicitation and Advertising*, SHEARMAN & STERLING LLP (July 18, 2013), http://www.shearman.com/~media/Files/NewsInsights/News/2013/08/Greene-Publishes-Article-in-iThe-Hedge-Fund-Law-_/Files/View-article-SEC-JOBS-Act-Rulemaking-Creates-Opp_/FileAttachment/HFLR-Reprint-71813-SEC-JOBS-Act-Rulemaking-Creat_.pdf; see also *Risk Roadmap: Hedge Funds and Investors' Evolving Approach to Risk*, BNY MELLON, at 2 (Aug. 2012), <http://www.bnymellon.com/foresight/pdf/riskroadmap-0812.pdf> (commenting on the increased transparency of hedge funds as result of the JOBS Act); Susan Lyon, *The Hedge Fund Advertising Ban Lifted: What Should Investors Know?*, NERD WALLET (July 24, 2013), <http://www.nerdwallet.com/blog/investing/2013/sec-hedge-fund-advertising-ban-lifted>.

89. Cole, *supra* note 86.

90. *Id.*

91. Richard Heller & Mark Maxwell, *The JOBS Act: Jumpstart My CTA*, CTA INTELLIGENCE (Apr. 29, 2013), <http://www.ctaintelligence.com/the-jobs-act-jumpstart-my-cta>.

92. Tower Fund Services, *SEC Ruling on Hedge Fund Advertising Ban Will Create Challenges and Opportunities*, PR WEB (July 16, 2013),

While accredited investors are theoretically fit to fend for themselves under the federal securities laws, and arguably are excluded from federal protections from investing in an opaque market, enhancing hedge fund transparency will inevitably support the changing landscape of the investment company industry. Increasingly, institutional investors, such as pension plans, insurance companies, and endowments, are adding hedge funds as a vital component to their underlying portfolios. And the risks and benefits of these hedge fund investments are indirectly passed on to the underlying retail investor constituents of these institutional investors. Yet many institutions are flocking to hedge funds because they enjoy greater flexibility to guarantee absolute returns through derivatives trading and unrestrained leverage, which are minimally available to their mutual fund counterparts.⁹³ For instance, the New York City retirement systems recently made the controversial decision to increase its hedge fund investments from \$450 million, to \$3.5 billion,⁹⁴ and the Princeton endowment has earmarked as much as 25 percent of its portfolio for hedge fund investments.⁹⁵ To the extent that hedge funds become an integral investment option to an increasing pool of accredited investors, such investors, along with any underlying retail constituents, will greatly benefit from investing in an industry whose participants can freely communicate its fundamental benefits and risks. Lifting the solicitation ban is a pivotal step in facilitating the flow of information to this growing group of investors.

In addition, several surveys have found that hedge fund investors have recently started to demand more transparency from industry participants. One such survey found that “82 percent of [hedge fund adviser] respondents reported an increase in demand for transparency from investors.”⁹⁶ Although transparency has greatly improved, especially since the dawn of the financial crisis, many investors still see the opacity of the industry as a primary concern.⁹⁷ Lifting the advertising ban will likely

<http://www.prweb.com/releases/2013/7/prweb10927179.htm>.

93. SEC STAFF REPORT, *supra* note 14.

94. Daniel Solin, *The New York Pension Plan Folly*, U.S. NEWS & WORLD REPORT, Mar. 7, 2013, <http://money.usnews.com/money/blogs/On-Retirement/2013/03/07/the-new-york-pension-plan-folly>.

95. Gillian Wee, *Princeton Endowment Plans to Cut Ranks of Private-Equity Managers in Half*, BLOOMBERG, Oct. 22, 2010, <http://www.bloomberg.com/news/2010-10-22/princeton-endowment-plans-to-cut-ranks-of-private-equity-managers-in-half.html>.

96. *The Evolution of an Industry: 2012 KPMG/AIMA Global Hedge Fund Survey*, KPMG INTERNATIONAL COOPERATIVE, at 5 (May 2012), <http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/the-evolution-of-an-industry/Documents/the-evolution-of-an-industry.pdf>.

97. See THE SHIFTING HEDGE FUND LANDSCAPE: THE NEW DYNAMICS OF HEDGE FUND COMPETITIVENESS, SEI (2012),

make funds more willing to share information, particularly since they will no longer be jeopardizing their business by freely sharing information with a growing list of investors.

This increased transparency will also give regulators, as well as researchers, more tools to appropriately investigate the perceived hazards associated with the continuous growth of the industry. As of February 2009, there were approximately 18,000 hedge funds in existence.⁹⁸ This number has likely grown and will continue to grow as investors increasingly allocate capital to alternative strategies.⁹⁹ Some of the hazards of this exponential growth include unrestrained leverage and derivatives trading, which also lead to an increase in speculation in the broader capital markets. Assuming that a large number of hedge funds will eventually utilize this new advertising power, outsiders will have more tools to effectively investigate the strengths and weaknesses of the industry. Both researchers and regulators will be able to scan hedge fund websites, which will presumably be more informative and educational. They will also be able to review interviews and other press releases for comparative and educational purposes. Additionally, they will be able to attend industry events and seminars where meaningful information about various industry participants would be freely shared. Overall, the increased transparency that will result from the removal of the solicitation ban will help outsiders better define the problems and accompanying solutions to the exponential growth of these private vehicles.

II. COMPETITION

Part II illustrates how the removal of the solicitation ban can enhance investor protection by fueling healthy competition within the industry. It begins by underscoring the general benefits to consumers that arise from competitive markets, and explains why such markets are protected by legal frameworks in both the United States and abroad. Part II then clarifies how advertising can help to increase competition within the hedge fund

http://www.seic.com/IMS/SEI_2012HedgeFundWhitePaper_Pt2_Summary.pdf. (finding that 57% of investors consider detail on the use of leverage the “top unmet information need”).

98. See *Hedge Fund Adviser FAQ's*, MANAGED FUNDS ASS'N, <https://www.managedfunds.org/hedge-fund-investors/faqs/hedge-fund-advisor/> (last visited Apr. 2, 2014) (citing PerTrac's February 2009 data on hedge funds).

99. CITIGROUP INC., *THE RISE OF LIQUID ALTERNATIVES & THE CHANGING DYNAMICS OF ALTERNATIVE PRODUCT MANUFACTURING AND DISTRIBUTION* 5 (2013), available at http://icg.citi.com/transactionservices/home/demo/tutorials8/Hedge_Fund_May2013/ (predicting that “the global demand for liquid alternatives for the retail audience [will] reach[] \$939 billion by 2017”).

industry, which will give investors more tools to better optimize their investment decisions. It continues by identifying an additional benefit of competitive markets inasmuch as they foster innovation, particularly amongst new market entrants. Part II concludes with a general discussion of how increased competition could create more clearly defined industry norms and standards, which could lead to higher quality products dominating the hedge fund marketplace.

A. *Optimizing Investor Choice*

Competition generally refers to “a struggle or contention for superiority, and . . . a striving for the custom and business of people in the market place.”¹⁰⁰ In 1776, Adam Smith was one of the first to recognize the importance of securing competitive markets in the broader economy. He found that sustaining competition is extremely beneficial for society because it forces business owners to better serve their customers.¹⁰¹ When faced with stringent competition from rivals, businesses are incentivized to make superior products, while maintaining the lowest possible prices and production costs.¹⁰² These benefits were reiterated in a white paper that was presented to Parliament, which stated that “[w]ith strong competition firms are forced to work hard to win and keep customers. As a result, competition drives down prices and drives up quality and choice.”¹⁰³ When compared to a monopoly, where a single firm or subset of firms controls an entire industry, competitive markets yield greater efficiency in various aspects of any business.¹⁰⁴ Due to the many benefits of maintaining competitive markets, several laws exist, both in the United States and internationally, “to protect the process of competition in order to maximize consumer welfare.”¹⁰⁵ There is a global consensus that protecting competition is a necessary endeavor to create better functioning markets.¹⁰⁶

As discussed in Part II.C, this new power to advertise will create a

100. RICHARD WHISH & DAVID BAILEY, *COMPETITION LAW* 3 (7th ed. 2012).

101. GUNNAR NIELS, ET AL., *ECONOMICS FOR COMPETITION LAWYERS* 2–3 (2011).

102. *Id.* at 3.

103. DEPARTMENT OF TRADE AND INDUSTRY, *A WORLD CLASS COMPETITION REGIME*, 2001, Cm. 5233, at 1 (U.K.).

104. WHISH, *supra* note 100, at 4.

105. *Id.*; *see also* NIELS, *supra* note 101, at 3 (recognizing that people in the same trade have a tendency to get together, converse, and often create the unintended consequence of monopolistic behavior); ROBERT BALDWIN, ET AL., *UNDERSTANDING REGULATION: THEORY, STRATEGY, AND PRACTICE* 19 (2nd ed. 2012) (identifying deficient markets in which firms behave in such a way as to inhibit “healthy competition”).

106. *See* WHISH, *supra* note 100, at 18 (“[T]here is probably a greater global consensus on the desirability of competition and free markets today than at any time in the history of human economic behavior.”).

more transparent market, which will enhance competition amongst hedge funds. Competition is improved when “[b]uyers have complete information about the product being sold and the prices charged by each firm”¹⁰⁷ In removing the solicitation ban, investors will have more access to information about the investment strategies, fees and other key attributes of a larger multitude of funds. This enhanced transparency will help investors better optimize their hedge fund investments by making it easier to compare a larger range of competing products. Investors’ ability to compare data among various investment opportunities is arguably one of the most important skills associated with optimizing investment choices.¹⁰⁸ Providing investors with comparable data among multiple hedge funds allows them to appropriately ascertain whether a particular firm is competitive, whether it conforms to industry standards, and whether it is the most optimal use of their limited capital.¹⁰⁹

While these investors often constitute high-net-worth individuals and prominent institutions that are performing substantial due diligence on each prospective investment, the due diligence process is extremely expensive and time consuming, which makes it difficult for investors to gain an accurate overview of the broader hedge fund marketplace. According to one study, a standard due diligence investigation for a single hedge fund can entail between 75 and 100 hours.¹¹⁰ Andrew Golden, the President of the Princeton University Investment Company, previously stated that his company utilizes an extremely rigorous due diligence process in which approximately 400 hours are spent investigating a single fund, and 70 additional hours per year are spent doing ongoing monitoring.¹¹¹ Instead of simply focusing on a single hedge fund strategy, enhanced competition can provide investors with a broader overview of multiple hedge fund products. This can be viewed as “enabling market choices” so that investors can more appropriately allocate their capital to optimal hedge fund investments.¹¹²

107. Definition of Perfect Competition, INVESTOPEDIA, <http://www.investopedia.com/terms/p/perfectcompetition.asp>.

108. Sharon Hannes, *Comparisons Among Firms: (When) Do They Justify Mandatory Disclosure?*, 29 J. CORP. L. 699, 702 (2004).

109. See *id.* (concluding that comparison of firms by public shareholders of a given firm is “likely to instigate voluntary disclosure”).

110. Stephen J. Brown et al., *Hedge Fund Due Diligence: A Source of Alpha in a Hedge Fund Portfolio Strategy* 10 (New York University Stern School of Business Working Paper Series, Working Paper No. FIN-07-032, 2011), available at <http://ssrn.com/abstract=1016904>.

111. *Hedge Funds and Systemic Risk in the Financial Markets: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 111 (2007) (statement of Andrew K. Golden, President, Princeton Univ. Inv. Co).

112. Robert G. Vaughn, *Transparency in the Administration of Laws: The Relationship*

In a similar vein, several industry participants agree that the solicitation ban has made it difficult for investors to make optimal investment decisions. For example, Richard Lashley, co-founder of PL Capital LLC, previously noted that “[u]nder the current opaque system, hedge fund investors usually find only one or two opportunities before making a decision With advertising, investors could review numerous possible strategies before choosing one.”¹¹³ James Hedges, founder, president and chief investment officer of LJH Global Investments LLC, similarly noted that “[i]nvestors should be able to see the entire universe of choices available to them, and as a result, they will be able to make informed decisions.”¹¹⁴ Kennon, a best-selling financial author, also observed that the advertising ban “[made] it nearly impossible for you to learn about hedge fund opportunities unless you ha[d] an existing relationship with an affiliated broker-dealer.”¹¹⁵ Douglas Berman, a managing member at a law firm, also stated that allowing hedge funds to advertise would cause “more investors [to] gain access to more deals as people become accustomed to distributing offering documents in a manner that was previously considered to be general solicitation.”¹¹⁶

Overall, several industry participants and, at one point, the SEC staff, have concluded that the solicitation ban was largely outdated. Removing the ban is a step in the right direction, as it will serve as a mechanism to improve competition within the industry, which will help investors to optimize investment decisions within the burgeoning private fund industry. However, certain regulatory loopholes still remain, particularly with respect to developing standardized valuation mechanisms and resolving conflicts of interest related to valuation practices. Resolving these loopholes would further assist in optimizing investor choice, but these issues have not been specifically addressed by the Advisers Act or the newly adopted JOBS Act. These loopholes are further discussed in Part IV.A below.

B. Promoting Innovation

An additional benefit of a competitive market is that “it [may] have the dynamic effect of stimulating innovation as competitors strive to

Between Differing Justifications for Transparency and Differing Views of Administrative Law, 26 AM. U. INT’L L. REV. 969, 971 (2011).

113. Ron Orol, *Pitching the Hedge*, THE DAILY DEAL, Nov. 3, 2003.

114. *Id.*

115. Joshua Kennon, *Investing in a Hedge Fund Can Be Difficult*, ABOUT.COM, <http://beginnersinvest.about.com/od/hedgefunds/a/how-to-invest-in-hedge-funds.htm>.

116. Lyon, *supra* note 88.

produce new and better products for consumers.”¹¹⁷ As to the hedge fund industry, removing the solicitation ban will make it easier for smaller, emerging funds, which tend to offer more innovative strategies at lower prices, to more easily access this market.¹¹⁸ The previous solicitation ban made it difficult for such funds to effectively compete with their larger, more-established counterparts, many of which have throngs of investors waiting to invest.¹¹⁹

Under this prior regime, since any broad-based communication was severely restricted as described in Part I.A above, hedge fund advisers could only solicit investors for which they had a sufficient preexisting relationship. Since new advisers often do not have access to these relationships, they would have to purchase such access from placement agents, who would have already constructed databases comprised of prescreened accredited investors. This system of “paying for access” is often referred to as an “old boys club,” which thrives on insider privilege and exclusivity.¹²⁰ Consequently, the solicitation ban made it difficult for such funds to raise sufficient capital to access an accredited investor audience.

A recent study conducted by PerTrac, an organization that provides innumerable services to investment professionals, revealed that returns have historically been higher for these emerging funds.¹²¹ This study found that between 1996 and 2011, funds with less than \$100 million in assets returned 12.5 percent annually, while funds with over \$500 million in

117. WHISH, *supra* note 100, at 4.

118. See AMERICAN LAW INSTITUTE, HEDGE FUND MARKETING: UNDERSTANDING THE JOBS ACT, 7 (2012), thehfa.org/articlePDFs/JOBSact.pdf (stating that “[a]ll four panelists agreed that the JOBS Act will have the greatest effect on emerging managers, including both small and midsize managers looking for increased exposure and AUM, as well as start-ups.”); Hedge Fund Ass’n, *supra* note 12; *Small and Large Hedge Fund Managers View JOBS Act Through Different Lens*, HEDGE FUND MARKETING ALLIANCE, (July 11, 2012), <http://www.hedgefundmarketing.org/small-and-large-hedge-fund-managers-view-jobs-act-through-different-lens> (concluding that “emerging managers would be more enticed to cast their lot and enter the industry” as result of the new solicitation rules).

119. Amit Chokshi, *Hedge Fund Marketing’s Gray Area*, SEEKING ALPHA (Feb. 1, 2010), <http://seekingalpha.com/article/185671-hedge-fund-marketings-gray-area>; Lyon, *supra* note 88 (quoting Peter Turchan, Partner at Ready to Run Designs, who said “I think that the recent lift will not cause drastic change to the industry or greatly effect [sic] investors, but will [allow] lesser known funds to compete on a larger scale and reach a larger audience of potential investors.”).

120. Tom Dworzanski, Comment Letter Regarding Section 201 of JOBS Act (June 7, 2012), <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-23.pdf>.

121. PERTRAC, IMPACT OF FUND SIZE AND AGE ON HEDGE FUND PERFORMANCE, 4 (2011), <http://www.nasp-ny.org/files/pdf/PerTrac-Impact-of-Fund-Size.pdf> [hereinafter PERTRAC] (finding that “[s]mall funds outperformed mid-size and large funds in 2010, returning 13.04%, 11.14%, and 10.99%, respectively”).

assets returned 9.2 percent annually.¹²² Analysts have suggested that this performance gap exists because these new managers are often introducing innovative and novel strategies in an effort to guarantee a performance fee for management.¹²³ Hedge funds typically charge both a performance fee (approximately 20 percent of profits) and a management fee (approximately 2 percent of net assets), but larger funds that manage a large volume of assets can depend solely on the management fee for profits, whereas smaller funds must actually earn a profit in order to generate sizable income. These larger, more-established funds may also be more hesitant to take on innovative risks as they are often subject to constraints imposed by a growing population of institutional investors, such as pension plans and insurance companies.¹²⁴ These investors may demand a more risk-averse strategy in order to safeguard their investment.¹²⁵ To the extent that restricting marketing activities could promote the flow of productive assets to newer and more innovative funds, lifting this ban could promote healthy competition within the industry.

Such investors may also benefit from having this increased access to a larger range of hedge funds. As previously stated in Part I above, these vehicles enjoy greater flexibilities to guarantee absolute returns through derivatives trading and unrestrained leverage, which are minimally available to their mutual fund counterparts. The reliance on unverified media reports or other forms of unreliable data can be problematic as these sources often create an unfairly negative depiction of these vehicles, especially since it has proven difficult for advisers to promote their products in any public medium.

C. Higher Quality Funds

A number of prominent hedge funds have been implicated in widely publicized scandals such as the Long-Term Capital Management debacle,¹²⁶ the massive Amaranth failure,¹²⁷ and, most recently, the Bear

122. Stan Luxenberg, *Good Hedge Funds Come in Small Packages*, WEALTH MANAGEMENT.COM (May 14, 2013), <http://wealthmanagement.com/alternative-investments/good-hedge-funds-come-small-packages>.

123. *Id.*

124. Katherine Burton, *Soros Says Hedge Funds Can't Beat Market Because of Fees*, BLOOMBERG (Jan. 25, 2013, 2:25 PM), <http://www.bloomberg.com/news/2013-01-25/soros-says-hedge-funds-can-t-beat-market-because-of-fees.html>.

125. *Id.*

126. See generally, ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* (2001) (providing a detailed account of the near failure of Long-Term-Capital Management, which likely imploded because of its excessive leverage—its leverage exceeded \$100 billion, although it only had about \$1.8 billion in assets).

Stearns fiasco, where “the funds, [which were] filled with some of the most explosive and high-risk securities available, imploded, evaporating \$1.6 billion of investor assets”¹²⁸ While these funds were undoubtedly engaged in extremely risky investment schemes that exposed their investors, as well as the economy, to egregious financial losses, the hedge fund industry, taken as a whole, encompasses an extremely heterogeneous class of vehicles. These entities employ several different categories of investment strategies and management styles, some of which may or may not entail high-risk investments. The term “hedge” refers to funds’ historic practice of using various strategies in order to hedge, or protect, their portfolios against market losses.¹²⁹ For example, an investment adviser could simultaneously take long and short positions in the same type of instrument in order to ensure a return in both high and low markets.¹³⁰ This was essentially how Alfred Winslow Jones structured the first hedge fund in 1949.¹³¹ He used short sales and leverage to create returns that had a low correlation to general market performance.¹³² Today, however, a multitude of hedge fund strategies exist, some of which may or may not hedge their investments and/or maintain excessive leverage.¹³³

Given this vast array of hedge fund strategies and management styles, advertising can be a useful tool for these vehicles to effectively distinguish themselves from the pack. Moreover, this new opportunity for hedge funds to engage in healthy competition could give “high-value” advisers the tools to successfully promote their brands to a wider audience.¹³⁴ As Professor Allen Ferrell of Harvard Law School recently stated, “[h]igh-value firms will be more likely to raise external finance if improved disclosure of firm-specific information is available at the time the firm is raising capital, given the increased ability of the market to differentiate between high-value and low-value firms.”¹³⁵ Marketing tools could make it easier for hedge funds to publicly disclose distinguishable characteristics about their strategies,

127. Kristen French, *Will Amaranth Debacle Curb Enthusiasm for Hedge Funds of Funds?*, WEALTH MANAGEMENT (Sept. 20, 2006), <http://wealthmanagement.com/news/will-amaranth-debacle-curb-enthusiasm-hedge-funds-funds> (reporting that Amaranth Advisors lost \$3 billion of investment assets “due to wrong bets on natural gas prices”).

128. Landon Thomas, Jr., *Prosecutors Build Bear Stearns Case on E-Mails*, N.Y. TIMES, June 20, 2008, http://www.nytimes.com/2008/06/20/business/20bear.html?_r=0.

129. JOSEPH G. NICHOLAS, INVESTING IN HEDGE FUNDS 15 (2005).

130. *Id.* at 14–15.

131. FILIPPO STEFANINI, INVESTMENT STRATEGIES OF HEDGE FUNDS 2 (2006).

132. *Id.*

133. *What is a Hedge Fund?*, HENNESEE GROUP LLC, <http://www.hennesseegroup.com/hedgefund/index.html>.

134. AMERICAN LAW INSTITUTE, *supra* note 118, at 9.

135. Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81, 93 (2007).

such as their leverage practices, diversification requirements, liquidity, volatility, and other financial attributes. Advertising can also make it easier for such advisers to distinguish their specific disclosure practices as well as their unique approaches in managing operational risk, which “include organizational aspects such as the reliability of back-office operations, legal infrastructure, accounting and trade reconciliation, personnel issues, and the day-to-day management of the business.”¹³⁶ Highlighting strengths regarding the management of operational risk is a great way for advisers to distinguish themselves as “high value” investments, given that most hedge fund failures have resulted from operational inefficiencies.¹³⁷

This increased competition could eventually discourage “low-value” funds from entering the industry, thereby improving the overall quality of hedge fund products. Since this new advertising power will help investors more easily identify industry norms in terms of leverage management, operational risk, and other key attributes, they would presumably be less likely to allocate capital to funds that have not engaged in similar practices. To the extent that it becomes an industry norm to make ongoing disclosures to investors regarding trading positions, ongoing risk management, and material changes to personnel and/or infrastructure, investors may start demanding comparable disclosures from all prospective funds. In effect, competing funds may have a greater incentive to comply with these emerging “high-value” standards.

This resulting competition can also lead to lower fees charged to investors.¹³⁸ As background, these fees can include both the management and performance fees paid to the primary investment adviser (briefly described above), as well as any additional service provider payments, which can include fees charged by auditors, lawyers, brokerage firms, placement agents, and administrators. For hedge funds that operate as fund-of-funds, where such advisers select a range of underlying funds for investment as opposed to allocating to its own distinct investments, additional fees are charged for investigating and monitoring the fund’s underlying funds, and a percentage of the underlying funds’ fees is also passed down to investors. Furthermore, allowing funds to undertake their own advertising efforts could reduce the sales charges paid to placement

136. Andrew W. Lo, *Risk Management for Hedge Funds: Introduction and Overview*, 57 FIN. ANALYST J. 16, 31 (2001), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=283308.

137. See Gareth Jones, *Operational Due Diligence: Increased Demands for Hedge Fund Managers and Investors*, THE HEDGE FUND J. (June 9, 2010), <http://www.thehedgefundjournal.com/node/6559> (“Hedge fund managers who build a robust business infrastructure will suffer fewer errors and less disruption.”).

138. Orol, *supra* note 113.

agents.¹³⁹ As discussed in Part I.A, placement agents are typically hired to help sell fund interests to prospective investors.¹⁴⁰ To the extent that hedge funds are able to efficiently lower their underlying fees and publicly advertise such practices, this would presumably induce competitors to engage in comparable “fee reduction” activities.¹⁴¹ One source has found that increased competition among smaller funds is already leading to an overall decrease in fees charged to hedge fund investors.¹⁴² This will likely continue as the solicitation ban makes it easier for smaller funds to access private markets.

Competition has similarly helped to reduce overall fees charged to investors in the heavily-regulated mutual fund industry. Since mutual funds are public companies registered under the federal securities laws, they have historically held the power to advertise in any broad-based medium. As a result, a recent study found that the mutual fund industry is extremely competitive, which makes investors “quite sensitive to the fees that they pay.”¹⁴³ This phenomenon has gained recent attention with the advent of exchange traded funds, which are a class of investment companies that bundle securities that are listed under a particular index.¹⁴⁴ As one source noted:

“the so-called fee war in the exchange traded fund space has helped slash annual investment costs on a number of fund products, and it looks like it is paying off for both providers and investors. Last September, Charles Schwab reduced its fees on a number of funds . . . to 0.04%, the lowest on the market, from the original 0.06% expense ratio”¹⁴⁵

139. Ryan C. Fuhrmann, *Hedge Fund Fees: Exotic Expenses*, INVESTOPEDIA (July 10, 2013), <http://www.investopedia.com/articles/investing/071013/hedge-fund-fees-exotic-expenses.asp>.

140. *Id.*

141. Lyon, *supra* note 88.

142. *Hedge Fund Fees Fall*, FINALTERNAIVES (Sept. 9, 2013, 11:24 AM), www.finalternatives.com/node/24644.

143. Ben Baden, *Why The Mutual Fund Industry Is Highly Competitive*, U.S. NEWS & WORLD REPORT (Apr. 9, 2010), <http://money.usnews.com/money/blogs/Fund-Observer/2010/04/09/why-the-mutual-fund-industry-is-highly-competitive>; *see generally*, R. GLENN HUBBARD ET AL., THE MUTUAL FUND INDUSTRY: COMPETITION AND INVESTOR WELFARE (2010) (outlining the processes by which the courts determine whether or not mutual fund fees are excessive).

144. *Definition of ETF*, INVESTORWORDS.COM, <http://www.investorwords.com/1755/ETF.html>.

145. Tom Lydon, *ETF Fees: Competition is a Good Thing*, ETF TRENDS (June 18, 2013, 4:30 PM), <http://www.etftrends.com/2013/06/etf-fees-competition-is-a-good-thing>; *see also*, Aaron Levitt, *How the ETF Fee War Benefits Investors*, INVESTOPEDIA (Feb. 28, 2013), <http://www.investopedia.com/stock-analysis/2013/how-the-etf-fee-war-benefits-investors-spy-voo-xle-schb0214.aspx> (demonstrating how firms are competing by lowering ETF

Thus, competition within the mutual fund industry has led to the creation of innovative products that have effectively lowered overall fees charged to investors.

III. FRAUD

Part III explains how the removal of the solicitation ban can actually deter fraud in certain respects. It first illustrates how the increase in competition will make it more difficult for fraudulent advisers to solicit prospective investors. Part III continues by identifying portions of the newly adopted Rule 506(c) that serve to deter fraudulent investors from utilizing false advertisements. This part concludes with a brief summary of the various frameworks provided under federal securities laws, particularly the Advisers Act, which directly regulates investor communications. These existing frameworks will serve as yet another mechanism to effectively prevent fraudulent advisers from using false advertising to induce unsuspecting investors.

A. Advertising Can Push Out Bad Actors

The resulting increase in competition will probably make it more difficult for fraudulent advisers to rival their non-fraudulent counterparts. Since increased competition can help to optimize investor choice, foster innovation, and promote higher quality products, “bad-actors” may find it more difficult to attract prospective investors. Even still, advertising carries a latent risk that investors will be induced to invest in fraudulent investment schemes.¹⁴⁶ Investors may simply flock to hedge funds that have earned high returns without considering other key attributes like risk management, leverage activities, and long-term investment goals, all of which are frequently disregarded by fraudulent advisers. This concern is legitimate, especially since the North American Securities Administrators Association found that Rule 506 offerings led to the highest number of state administered enforcement actions in 2011.¹⁴⁷

investment fees for their products); Brendan Conway, *Will BlackRock Cut ETF Fees?*, BARRON'S (Sept. 8, 2012), <http://online.barrons.com/article/SB50001424053111904294104577631472724967672.html>.

146. See *supra* note 13 and accompanying text.

147. N. Am. Sec. Adm'rs Ass'n, Inc., Comment Letter Relating to Section 201 of JOBS Act (Oct. 3, 2012), <http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-to-SEC-re-Rule-506.pdf>; *Laws Provide Con Artists with Personal Economic Growth Plan*, N. AM. SEC. ADM'RS ASS'N, INC. (Aug. 21, 2012), <http://www.nasaa.org/14679/laws-provide-con-artists-with-personal-economic-growth-plan>.

While fraudulent advisers may be tempted to use advertisements to attract prospective investors, this new power to advertise can actually serve to deter fraud in certain respects. Given the increased scrutiny that will result from this new freedom to advertise, it may be more difficult for fraudulent funds to fly under the radar. As one source noted:

“the new rules are going to entice hedge funds to share more information, and in some cases, lure money managers into the public eye. And once you’ve gone on the air and shown the world what a brilliant and disciplined character you are, it’s a little bit harder to engage in [fraudulent activities].”¹⁴⁸

Essentially, once a hedge fund makes communications in a public forum, it may thereafter be subjected to increased scrutiny from existing and prospective investors, as well as state and national regulators.

Similarly, enhanced marketing activities could remove the historical reliance on trusted referrals for a certain subset of hedge fund investors. Commentators have found that this reliance on referrals, as well as the general availability of the private placement exemptions, assisted in the perpetuation of the Madoff scandal and other comparable Ponzi schemes.¹⁴⁹ With respect to the Madoff scandal, “[r]elatively few third-party entities had access to performance statistics and operational information” about the underlying advisory business of his firm.¹⁵⁰ If such information were publicly available to a broader audience, this notorious Ponzi scheme could have been identified at an earlier stage. By and large, the secrecy that resulted from the solicitation ban created opportunities for private advisers to take advantage of prospective investors.¹⁵¹

Regulators still must consistently monitor the extent to which advertising disclosures dupe investors into investing in fraudulent schemes. The SEC has various tools at its disposal to combat these disclosures under

148. Patrick Clark, *Let the Hedge Funds Speak! Why New Rules on Marketing May Be a Good Thing*, N.Y. OBSERVER (Sept. 10, 2012, 3:16 PM), <http://observer.com/2012/09/how-hedge-fund-marketing-rules-could-root-out-bad-actors-really>.

149. *The Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Hearings Before the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. (2009) (statement of John C. Coffee, Adolf A. Berle Professor of Law, Columbia University Law School), available at <http://www.hedgefundlawblog.com/professor-coffee-testimony-at-senate-madoff-hearing.html>; Orol, *supra* note 113.

150. Stephen Brown et al., *Trust and Delegation 1* (May 16, 2011) (unpublished manuscript) (on file with New York University Stern School of Business), available at <http://ssrn.com/abstract=1456414>.

151. Daniel Strachman, *Hedge Funds: It's Still Caveat Broker. Their Mystique Lures Clients, but the Dearth of Information Can Be Dangerous*, ON WALL ST. (July 1, 2003), <http://www.highbeam.com/doc/1G1-104549302.html>.

the new Rule 506(c), as well as the Advisers Act. The effectiveness of these regulatory frameworks will be further discussed in Parts III.B and III.C, below.

B. Amendments to Rule 506 Deter Fraud

The final rule provided under 506(c) incorporates provisions that would partially prevent and/or deter fraudulent investment schemes. First, in order for issuers to take advantage of this new power to advertise, they must take “reasonable steps to verify” that prospective investors actually qualify as accredited.¹⁵² This heightened standard is designed to prevent retail investors from inadvertently investing in these private funds since, theoretically, such investors cannot adequately fend for themselves.¹⁵³ Knowingly accepting such investors into private hedge fund vehicles would constitute a fraudulent investment scheme under the federal securities laws. Previously, hedge funds were not required to make additional inquiries into the actual status of its investors, beyond the “check-the-box” representation signed by investors on their subscription agreements.

Under the new Rule 506(c), the SEC maintains a flexible standard for determining whether new verification requirements are legitimate, which will depend on the facts and circumstances related to the “nature of the purchaser, the amount and type of information the purchaser has about the issuer, and the nature of the offering (including the manner in which the purchaser was solicited).”¹⁵⁴ However, the SEC provides a non-exclusive list of safe harbors that would meet this heightened requirement.¹⁵⁵ For example, “in verifying whether a natural person is an accredited investor on the basis of income, an issuer is deemed to satisfy the verification requirement in Rule 506(c) by reviewing copies of any [IRS] form . . .”¹⁵⁶ In addition,

“an issuer is deemed to satisfy the verification requirement in Rule 506(c) by obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps to verify that the purchaser is an

152. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959 (July 10, 2013), at 19, available at <http://www.sec.gov/rules/final/2013/33-9415.pdf> [hereinafter, Final Rule 506 Release].

153. *Id.*

154. Heller, *supra* note 91.

155. Final Rule 506 Release, *supra* note 152, at 27–28.

156. *Id.* at 36.

accredited investor”¹⁵⁷

Second, the SEC adopted a revision to Form D, which is a required public filing for private companies relying on the Rule 504, 505 or 506 exemptions provided under Regulation D.¹⁵⁸ The general purpose of this form is to notify the SEC, as well as the general public, that an issuer is engaged in a private offering. It must be filed “no later than 15 calendar days after the ‘date of first sale’ of securities.”¹⁵⁹ Under the final amendment, issuers who choose to advertise must indicate that they are relying on the accompanying 506(c) exemption on their respective Form D filings. As such, the SEC can use this notification mechanism to scrutinize the communications made by private issuers. This could provide a useful tool to monitor communications that would otherwise be used to dupe investors into investing in fraudulent schemes. In addition, this notification requirement could deter fraudulent advisers from using advertisements to effectuate their schemes, as they would presumably be reluctant to provide the SEC with such constructive notification.

Furthermore, Rule 506 was recently amended to reflect the mandated disqualification of “bad-actors” pursuant to Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”).¹⁶⁰ This newly incorporated “bad-actor” provision serves to “disqualify securities offerings from reliance on [Rule 506] if the issuer or other relevant persons (such as underwriters, placement agents and the directors, officers and significant shareholders of the issuer) have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.”¹⁶¹ Thus, if a particular “disqualifying event” occurs with respect to any “covered person” related to the offering in question, then the issuer will lose its Rule 506 exemption.¹⁶² This new provision serves as a major deterrent against fraud, as advisers who are convicted of securities fraud (along with any covered persons) are automatically disqualified from relying on the Rule 506 exemption.

157. *Id.* at 38.

158. *Form D: Notice of Exempt Offering of Securities*, SEC.GOV, <https://www.sec.gov/about/forms/formd.pdf>.

159. *Id.* at 5.

160. Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, Securities Act Release No. 9414 (July 10, 2013), <http://www.sec.gov/rules/final/2013/33-9414.pdf> [hereinafter, Final Bad Actor Release].

161. *Id.* at 7.

162. *Id.*

C. Advisers Act Constraints Deter Fraud

The SEC refrained from imposing additional restrictions on the content and form of general solicitations because the Advisers Act already imposes significant restrictions on investor communications. In its adopting release, the SEC stated:

“[w]e believe that investment advisers that have implemented appropriate policies and procedures regarding, among other things, the nature and content of private fund sales literature [as required under the Advisers Act], including general solicitation materials, are less likely to use materials that materially mislead investors or otherwise violate the federal securities laws.”¹⁶³

Several other commentators agree that the existing restrictions placed on both registered and unregistered advisers will sufficiently derail fraudulent advertisements.¹⁶⁴

The general anti-fraud provisions provided under the federal securities laws apply to all advisers, even if they are exempt from registration. Under Section 10b-5 of the Securities Exchange Act of 1934, exempt advisers cannot utilize “any device, scheme, or artifice to defraud” or “make any untrue statement of a material fact or to omit to state a material fact . . .” in any disclosures provided to investors.¹⁶⁵ Similarly, under Section 206 of the Advisers Act, advisers are prohibited from using any fraudulent “device, scheme or artifice” to defraud clients, which largely restricts the extent to which advisers can use public disclosures to induce investors into fraudulent schemes.¹⁶⁶ It is easier for investors to assert Section 206 actions, as opposed to Rule 10b-5 actions, because scienter is not always a required element in proving such violations.¹⁶⁷ Proving scienter can be a difficult hurdle for investors to overcome, as it requires investors to prove that advisers acted with some degree of intent in engaging in the alleged fraudulent practice. Since this scienter requirement is often an excluded element, investors, as well as the SEC, generally have more freedom to

163. Final Rule 506 Release, *supra* note 152, at 53.

164. See e.g., Press Release, Alt. Inv. Mgmt. Ass’n, AIMA Supports Removal of Ban on General Solicitation and Advertising by US Hedge Fund Managers (July 12, 2012), <http://aima.org/en/media/press-releases.cfm/id/F340E5F1-85D6-4A20-998CC41AC04E2A96> (“AIMA CEO Andrew Baker said: ‘With the advent of greater regulation, transparency and oversight of the hedge fund industry, we believe that the time has come to bring the general solicitation and advertising regulations in the US more in line with what we see as more flexible marketing and advertising regimes adopted elsewhere in the world.’”); BlackRock Letter, *supra* note 12, at 2.

165. 17 C.F.R. § 240.10b-5 (2013).

166. 15 U.S.C. § 80b-6(1) (2006 & Supp. IV 2010).

167. LEMKE ET AL., *supra* note 76, §3:22.

pursue Section 206 actions. Recent examples of Section 206 violations include “overstating performance results” and “[f]ailing to disclose in investor communications that a large portion of the fund’s superior performance was due to investments in initial public offerings that are unlikely to have the same impact as the fund grows”¹⁶⁸

With the passage of the Dodd-Frank Act,¹⁶⁹ many hedge fund advisers are now required to register under the Advisers Act. More specifically, private advisers who manage \$150 million or more in assets must register under the Advisers Act.¹⁷⁰ This new registration requirement imposes certain disclosure requirements, such as descriptions of the advisory services offered, material conflicts of interest, any pending disciplinary actions, advisory fees charged, and other general business descriptions.¹⁷¹ It also subjects advisers to additional fiduciary obligations, certain recordkeeping requirements, as well as various restrictions on the manner in which communications are presented to investors.¹⁷² These restrictions on communications will also apply to the content and form of any general solicitations utilized by hedge fund advisers. Generally speaking, the SEC actively monitors investment adviser communications and “regularly imposes significant sanctions when it finds what it believes are misleading or inappropriate advertising practices”¹⁷³

While this Article is not intended to give a comprehensive overview of the various ways in which the Advisers Act restricts advertising, it does provide key examples of how these restrictions can serve to continuously deter fraud. For instance, investor testimonials that endorse or promote any particular adviser are broadly restricted from being referenced in any distributed advertisement.¹⁷⁴ This restriction is designed to prevent investors from believing that all prior or existing investors have experienced the same positive results, and it similarly prevents investors from ignoring potentially unfavorable attributes of a particular investment.¹⁷⁵

With respect to the numerous restrictions placed on the presentation of performance, all such presentations must be presented fairly.¹⁷⁶ Under this

168. *Id.*

169. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter “Dodd-Frank Act”].

170. Dodd-Frank Act § 403 (codified as amended at 15 U.S.C.S. § 80b-3(b)).

171. 15 U.S.C.S. § 80b-4.

172. *Id.*

173. LEMKE ET AL., *supra* note 76, §3:38.

174. 17 C.F.R. § 275.206(4)-1 (2013).

175. LEMKE ET AL., *supra* note 76, §3:35.

176. Allied Invs. Co., SEC No-Action Letter, 1979 WL 14627 (May 24, 1979) (holding that the “Brochure Rule” does not require disclosure of performance information to clients,

broad standard, the SEC has published several no-action letters and instituted various enforcement actions, each of which provides additional guidance on determining whether a particular performance presentation is inherently unfair. The leading guidance is provided in a no-action letter that was issued to Clover Capital Management, Inc. in 1986 (the “Clover Letter”).¹⁷⁷ The Clover Letter places multiple conditions and requirements on the presentation of model performance, which are essentially performance figures that are derived from hypothetical portfolios. Advisers who choose to advertise model performance must prominently disclose the general limitations of evaluating hypothetical portfolios, as well as any other material attributes and/or limitations associated with the presentation.¹⁷⁸

With respect to the presentation of actual performance, the Clover Letter requires that advisers make multiple accompanying disclosures, some of which include the potential effects of market conditions, whether the results reflect reinvestment of earnings, and “any material conditions, objectives, or investment strategies used to obtain the results portrayed.”¹⁷⁹ Actual performance must also incorporate deductions for any and all fees passed down to investors, which can include advisory fees, brokerage commissions, and other expenses incurred by the fund.¹⁸⁰ In addition, Rule 206(4)-1 places certain limitations on selecting profitable portfolios for a presentation, particularly when the adviser simultaneously advised unprofitable portfolios.¹⁸¹

On the whole, the Advisers Act has several existing frameworks that will continue to deter advisers from inducing investors with fraudulent communications. The various restrictions placed on performance presentations help to ensure that investors are not relying on fraudulently derived results. However, there are certain loopholes with respect to hedge fund valuation practices, as well as a certain subset of smaller funds, that are not specifically addressed by the Advisers Act or the newly adopted JOBS Act. These loopholes are further discussed in Part IV.A below.

IV. FUTURE REGULATORY CHALLENGES

Although the removal of the solicitation ban can improve investor

but such information could be included in presentations).

177. Clover Capital Mgmt., Inc., SEC No-Action Letter, 1986 WL 67379 (Oct. 28, 1986).

178. *Id.*

179. *Id.*

180. *Id.*

181. 17 C.F.R. § 275.206(4)-1 (2013).

protection by expanding transparency, enhancing competition, and deterring fraud, future regulatory challenges still remain. These challenges include the inherent conflicts of interest and the lack of standardization with respect to hedge fund valuations, the fraud loophole created by smaller funds that escape oversight under the Advisers Act, and the potential increase in speculation that could significantly compromise investor confidence. Part IV begins by highlighting how the lack of standardized valuation practices will create unique challenges with respect to the evaluation of advertised performance results. It continues by identifying the existing conflicts of interest that create incentives for advisers to misreport valuations. Part IV then suggests possible solutions to these valuations challenges, some of which include third-party oversight and/or standardized methodologies for particular hedge fund investments. Part IV continues by identifying a key fraud loophole with respect to smaller funds that escape federal oversight under the Advisers Act. Such funds are frequently more susceptible to fraud than their larger counterparts. Thus, requiring Advisers Act registration for all advisers who utilize general solicitations may be the most viable solution. Part IV then explains how the continuous growth of the industry, which will likely be expedited with the removal of the solicitation ban, could increase speculative trading activities, potentially compromising investor confidence. Part IV concludes with a suggestion that the SEC and/or Congress mandate a study of the resulting speculation's effect on the markets, to be completed within two years after the passage of the JOBS Act.

A. Valuation Challenges

Numerous commentators, researchers and regulatory bodies have identified the valuation of hedge fund portfolios as one of the most prominent challenges facing prospective investors.¹⁸² Valuation mechanisms are central to hedge fund performance because such practices

182. See e.g., SEC STAFF REPORT, *supra* note 14, at 64; Housman B. Shadab, *Hedge Fund Governance*, 19 STAN. J.L. BUS. & FIN. 1 (2013) (observing that hedge fund governance suffers significant deficiencies in the reporting of valuations); Wulf A. Kaal, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 28 REV. BANKING & FIN. L. 581, 584 (2009) (arguing that “[w]ith the lack of regulatory oversight in most jurisdictions, as well as the general lack of self-discipline and internal controls, valuation is very likely to become the next major issue for the hedge fund industry.”); Mara Der Hovanesian, *The SEC Isn’t Finished with Hedge Funds*, BLOOMBERG BUSINESSWEEK, July 16, 2006, http://www.businessweek.com/magazine/content/06_29/b3993055.htm (discussing the challenges of implementing subjective valuation procedures for illiquid assets traded by hedge funds).

are directly linked to net asset value calculations, performance fees paid to managers and other service providers, performance and financial reports distributed to investors, and collateral required by hedge fund counterparties.¹⁸³ The challenges that arise with respect to these mechanisms generally fall within two distinct categories. The first category involves traded assets that are extremely difficult to value, which creates difficulties regarding standardization. The second category encompasses inherent conflicts of interest that expose hedge fund investors to an increased risk of fraudulent valuation reports, which is an additional loophole that is not sufficiently addressed under the JOBS Act, or any other recent regulatory action.

1. Lack of Standardization

Since hedge funds are not required to adhere to standardized valuation mechanisms for the wide range of instruments traded within the industry, it can be difficult for investors to assess the true nature of a particular fund's value.¹⁸⁴ Furthermore, this lack of standardization can make it difficult for investors to appropriately evaluate a potential hedge fund investment in relation to other comparable funds.¹⁸⁵ While the new power to advertise can result in greater comparability among hedge funds, as briefly discussed in Part III.A above, this benefit cannot fully be realized unless there is an accompanying standardized format for calculating valuations and performance data.

For example, two different advertisements for competing hedge fund products, each trading the same illiquid securities, could equally promote an annual return of 10%. However, each hedge fund adviser is free to use separate valuation mechanisms to derive the fund's value, and the financial statements that are provided by such hedge funds are not required to comply with generally accepted accounting principles ("GAAP") or be reviewed by a CPA.¹⁸⁶ An investment adviser may therefore select the

183. INT'L ORG. OF SEC. COMM'NS, PRINCIPLES FOR THE VALUATION OF HEDGE FUND PORTFOLIOS, 7 (2007), <http://www.fsa.go.jp/inter/ios/20070425/02.pdf> [hereinafter Valuation Report].

184. See generally Cary Martin, *Is Systemic Risk Prevention the New Paradigm? A Proposal to Expand Investor Protection Principles to the Hedge Fund Industry*, 86 ST. JOHN'S L. REV. 87, 120–124 (discussing the adverse effects resulting from the lack of standardization in the hedge fund industry).

185. See *id.* at 116–120 (discussing the inherent difficulties in comparing a large range of hedge fund investments).

186. Thomas C. Pearson & Julia Lin Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds*, 33 N.C. J. INT'L L. & COM. REG. 1, 29 (2007).

most favorable valuation principle without running afoul of the antifraud provisions provided under the federal securities laws. Investment advisers are thereby placed in the precarious position of having minimal economic incentives to choose the most accurate valuation mechanism. This is also problematic to the extent that “high-value” advisers are precluded from legitimately bolstering their brands by “low-value” advisers, who are effectively permitted to manipulate their funds’ overall worth through this lack of standardization. As SEC Commissioner Luis Aguilar stated, “if information is lacking, unreliable, or difficult to compare, investors will tend to ‘overpay’ for low-quality securities and ‘underpay’ for high-quality ones.”¹⁸⁷

Although some hedge funds trade instruments that are relatively easy to price, such as securities with readily available market quotations, others trade in a variety of illiquid and/or complex instruments that are exceedingly difficult to value. Certain kinds of distressed securities, over-the-counter structured notes, and other kinds of illiquid instruments traded by funds are not accompanied by reliable market information on their actual values.¹⁸⁸ With respect to collateralized debt obligations (“CDO”), which are investment vehicles that offer securitized interests in a pool of loan or debt instruments, a computer program could take days to value such instruments.¹⁸⁹ The mathematical models utilized by these computer programs often rely on “assumptions and forecasts that are subjective and open to question.”¹⁹⁰ Similarly, collateralized mortgage obligations, which are investment vehicles that offer securitized interests in a pool of mortgages, are so complex that counterparties within a CMO transaction could yield different values for the same CMO interest.¹⁹¹ Convertible bonds also present similar valuation difficulties as:

“[they] can be extremely complex to value and have limited

187. Luis Aguilar, Comm’r, U.S. Sec. & Exch. Comm’n, Capital Formation from the Investor’s Perspective, Address at the American Institute of CPA’s Conference (Dec. 3, 2012), <http://www.sec.gov/News/Speech/Detail/Speech/1365171491900#.U4Oc4vldWS0>.

188. Valuation Report, *supra* note 183, at 8.

189. Jennifer S. Taub, *Enablers of Exuberance: Legal Acts and Omissions that Facilitated the Global Financial Crisis* 2 (Univ. of Vt. Working Paper Series, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1472190; *Collateralized Mortgage Obligations*, SEC.GOV, <http://www.sec.gov/answers/tcmos.htm> (last visited May 26, 2014).

190. Christopher Kundro & Stuart Feffer, *Valuation Issues and Operational Risk in Hedge Funds*, 10 J. FIN. TRANSFORMATION 41, 42 (2004), <http://www.hedgefundprofiler.com/Documents/48.pdf>.

191. CHARLES R. MORRIS, THE TWO TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS AND THE GREAT CREDIT CRASH 42 (2008) (“These were exotic instruments that were almost never traded, so the prices were set by models, but Askin’s and the banks’ models produced different results.”).

liquidity. Broker quotes for convertibles can vary significantly for the same issue, and it can be difficult to determine the size for which any given quote is good. (In one convertible portfolio we recently studied, for example, the average difference between highest and lowest bid on the same issue was around 5%, with the largest deltas as high as 20%).”¹⁹²

Moreover, “[n]ew types of complex swaps, options, and hybrids are being developed constantly, and some hedge funds will make use of highly customized instruments in their portfolios.”¹⁹³ Given the wide variety of instruments traded by hedge funds, the industry would greatly benefit from the implementation of standardized methodologies.

2. Conflicts of Interest

By and large, hedge fund managers often possess exclusive control over the valuation mechanisms utilized by their respective funds, which creates unique conflicts of interest between themselves and their underlying investors.¹⁹⁴ Hedge fund advisers predominantly design, implement and monitor the valuation processes of their own managed portfolios.¹⁹⁵ Even for funds that hire third-party service providers or administrators to separately calculate valuations, most advisers retain full discretion to deviate from any provided final figures.¹⁹⁶ Since advisers are compensated based on the actual performance of the fund (which of course is derived from how its assets are valued), hedge fund managers have a conflict of interest in maintaining legitimate/fair mechanisms for investors, while ensuring the highest return possible for themselves.¹⁹⁷

Similarly, several empirical studies have proven that hedge fund advisers are, to a large extent, falsifying returns to earn higher fees and improve the reputation of their respective funds. A recent study investigated whether hedge fund advisers were significantly misreporting the value of their equity positions as recorded on Form 13F, which must be completed by all hedge funds that manage an aggregate fair market value of \$100,000,000 of publicly-traded equity securities.¹⁹⁸ This study found

192. Kundro, *supra* note 190, at 44.

193. *Id.* at 45.

194. Valuation Report, *supra* note 183, at 10.

195. *Id.*

196. *Id.* at 8.

197. Wulf, *supra* note 182, at 587–591 (providing an in-depth discussion of the various conflicts of interest related to both the payment of adviser fees and the calculation of valuations).

198. *Form 13F: Information Required of Institutional Investment Managers Pursuant to Section 13(f) of the Securities Exchange Act of 1934 and Rules Thereunder*, SEC.GOV,

that about seven percent (150,000 positions) of all reported equity positions held by hedge funds differed from the final closing price of such equities, even though the SEC requests that the provided value of such equities be consistent with their closing prices.¹⁹⁹ An additional study found that a large percentage of hedge funds advisers intentionally inflate December returns so as to earn a higher incentive fees and make the fund appear more attractive for potential investors.²⁰⁰ In a similar vein, a different study analyzed a database of due diligence reports provided by hedge funds to prospective investors.²⁰¹ Within this subset of reports:

“[1] [A]bout 18% of funds’ asset information either could not be verified independently . . . or disagreed with evidence from an alternative source [2] . . . performance related discrepancies . . . or verification problems . . . were noted for 14% of [due diligence] investigations [; and] [3] . . . 21% of managers . . . interviewed verbally stated incorrect information . . . when checked against written documentation, including poor recollection about basic levels of assets and performance. For example, one manager’s verbal assets under management figure was over \$300 million higher than the actual number.”²⁰²

In effect, this study found that despite the expensive and tedious due diligence processes implemented by many hedge fund investors, the provision of inaccurate disclosures is not an uncommon practice.²⁰³

Researchers have also found that many hedge fund advisers are intentionally smoothing returns so that their funds appear less volatile.²⁰⁴ One such study found that this practice of intentional smoothing was far more prevalent in hedge funds that trade illiquid securities, as well as in funds where the adviser is given wide discretion to control valuations.²⁰⁵

<http://www.sec.gov/about/forms/form13f.pdf>.

199. Gjergji Cici, et al., *The Valuation of Hedge Funds’ Equity Positions* (American Finance Association 2012 Chicago Meetings Working Paper, 2013), available at <http://ssrn.com/abstract=1664461>.

200. Vikas Agarwal, et al., *Do Hedge Funds Manage Their Reported Returns?*, 24 REV. FIN. STUD. 3281 (2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=891169.

201. Brown, *supra* note 150, at 12.

202. *Id.*

203. *Id.* at 24.

204. Olivier Le Marois & Riskdata, *Return Smoothing Practices: A Potential Threat for Alternative Investment Growth*, RISKDATA, <http://www.riskdata.com/files/resources/Hedge%20Funds/Riskdata%20Article%20on%20Return%20Smoothing.pdf>.

205. Gavin Cassar & Joseph Gerakos, *Hedge Funds: Pricing Controls and the Smoothing of Self-Reported Returns* 1 (Univ. of Chi. Booth Sch. of Bus., Working Paper

As stated by the authors of this article, “[t]he question is of economic importance because intentional smoothing can reduce the observed volatility of returns, thereby distorting commonly used risk adjusted performance measures such as Sharpe ratios and market betas.”²⁰⁶ This process of smoothing allows funds to further conceal risks, which complicates the process of sufficiently aggregating valuation profiles.

Valuation discrepancies have also led to significant losses for hedge fund investors. Beacon Hill Asset Management LLC (“Beacon Hill”), a hedge fund adviser based in Summit, New Jersey, was charged with fraudulent valuation representations that led to over \$300 million of losses for its investors.²⁰⁷ The SEC alleged that Beacon Hill manipulated its valuation procedures to disclose steady growth, while hiding significant losses by inflating the prices of securities held by one of its funds.²⁰⁸ This maintained the appearance of positive returns, even though the fund was actually decreasing in value.²⁰⁹ Similarly, Lipper & Co. (“Lipper”), an investment management firm based in New York, liquidated three of its funds after realizing previously undisclosed declines in market value, which contributed to losses exceeding \$315 million.²¹⁰ According to this firm, the losses resulted from the mispricing of the convertible-bonds, which are often illiquid and difficult to value.²¹¹ Lipper had previously disclosed to investors that the domestic fund experienced a 7% increase in profits, when it had actually suffered a decline of about 45%.²¹²

3. Possible Valuation Solutions

While it is difficult to create uniform valuation mechanisms for all hedge fund investments, since the strategies employed by hedge funds are heterogeneous and distinct from traditional investments, it is vital that certain standards are developed and applied consistently. This can perhaps be achieved by requiring third-party oversight for valuation procedures, so as to remove the existing conflicts of interest that currently incent certain advisers to report false performance results. In addition, creating separate

No. 09-43, 2009), available at <http://ssrn.com/abstract=1498601>.

206. *Id.*

207. Beacon Hill Asset Mgmt. LLC, Litigation Release No. 18745A, 2004 WL 1575235 (June 16, 2004).

208. *Id.*

209. *Id.*

210. Allison Bisby Colter, *Several Kenneth Lipper Hedge Funds Are Being Liquidated After Big Losses*, WALL ST. J., March 29, 2002, <http://online.wsj.com/news/articles/SB1017355983517177960>.

211. *Id.*

212. *Id.*

valuation procedures for different types of instruments or adopting the models proposed by the Managed Funds Association, or other similar organizations, could help to standardize performance figures.²¹³ This would make it even easier for hedge fund investors to optimize their investment decisions as the advertised performance figures could be more easily compared across various opportunities. Any such requirements should be mandated for all hedge funds that are registered under the Advisers Act.

B. Smaller Funds Escape Advisers Act Registration

Studies have also found that smaller funds, which will likely be the primary beneficiary of this new power to advertise, are much more likely to commit fraud.²¹⁴ One proffered reason for this phenomenon is that larger hedge funds attract a greater number of institutional investors, as opposed to high net-worth individuals.²¹⁵ Institutions are far more likely to expend a significant amount of resources performing extensive due diligence investigations on prospective investments.²¹⁶ This heightened due diligence process inevitably holds such advisers to a higher standard since their business practices are more closely scrutinized. In effect, if a hedge fund has a large number of institutional investors that are demanding more disclosure and greater transparency, then such advisers are less likely to participate in fraudulent investment activities. The removal of the solicitation ban could lead to a proliferation of fraudulent funds among emerging advisers, especially since they are much more likely to attract wealthy individuals, as opposed to prominent institutions.

Furthermore, the reliance on advertising by this increasing pool of

213. See generally Martin, *supra* note 184, at 131–141 (identifying possible solutions for developing standardized valuations).

214. See Matthew Lewis, *A Transatlantic Dilemma: A Comparative Review of American and British Hedge Fund Regulation*, 22 EMORY INT'L L. REV. 347, 372 (2008) (explaining that many of the fraud actions pursued by the SEC have been against funds with less than \$25 million in assets, which are not required to register); Anuj Gangahar, *SEC Rule Ignores Highest-Risk Category of Fund Fraud*, FIN. NEWS (Oct. 31, 2005), <http://www.efinancialnews.com/story/2005-10-31/sec-rule-ignores-highest-risk-category-of-fund-fraud>.

215. See Lewis, *supra* note 209, at 372 (commenting that registered hedge funds that pension funds invest in are not the problem); Amanda Cantrell, *Hedge Funds: A \$25 Million Loophole*, CNNMONEY.COM (Aug. 5, 2005, 2:20 PM), http://money.cnn.com/2005/08/05/markets/hedge_regulation/index.htm.

216. See Netty Ismail, *Institutions Damp Hedge Fund 'Startup Spirit,' Citi's Roe Says*, BLOOMBERG (Feb. 20, 2011), <http://www.bloomberg.com/news/2011-02-21/hedge-funds-startups-slow-as-investors-demand-track-record-citigroup-says.html> (discussing institutional investors' preference for large hedge funds).

wealthy individuals could create the presumption that the underlying offering has been registered with the SEC. Such investors may assume that due diligence is no longer required for prospective investments that have been publicly marketed. Corgentum Consulting, a firm which specializes in hedge fund due diligence, shared this similar concern in a report that summarizes the potential impact of the JOBS Act.²¹⁷ This report concluded that “[w]hen a broader, more aggressive marketing net is cast, smaller investors will likely show interest. These smaller investors may not be knowledgeable about fund operations or be equipped to perform operational due diligence.”²¹⁸ Thus, there is a substantial likelihood that a subset of prospective investors will rely solely on marketing materials without performing adequate due diligence on the hedge fund in question.

This is particularly problematic since smaller funds dominate a sizable portion of the industry. In fact, one study found that “[s]mall funds [funds with less than \$100 million under management], in 2010, comprised 71.39% of the hedge fund universe, mid-size funds 21.17%, and large funds 7.44%.”²¹⁹ In addition, advisers with less than \$150 million in assets under management in the United States are not required to register under the Advisers Act.²²⁰ While the antifraud provisions will still apply to such exempt funds, they will be excluded from the more stringent advertising restrictions and disclosure obligations discussed in Part IV.C. This creates a significant fraud loophole that could undermine the multiple benefits of removing the solicitation ban discussed at length in this Article.

Requiring all private advisers choosing to advertise to register under the Advisers Act could close this loophole. This would ensure that all advisers who utilize general solicitations are providing comparable disclosures to investors. Since many advisers are already registered under the Advisers Act pursuant to the Dodd-Frank Act, implementing this requirement for smaller advisers may prove to be the most cost-effective means of deterring fraud.

C. Speculation

Speculation generally refers to the selection of investments based on

217. *The JOBS Act Won't Affect Due Diligence — Or at Least Shouldn't...*, CORGENTUM (2012), http://corgentum.com/research/hedge-fund-operational-due-diligence-JOBS_Act.html.

218. *Id.*

219. PERTRAC, *supra* note 121, at 4.

220. The Dodd-Frank Act, § 408 (codified as amended at 15 U.S.C.S. § 80b-3 (2010)). Advisers who manage less than \$100 million of assets are subject to regulation by their respective states. *Id.* §410. However, this is still problematic because it can result in the production of inconsistent disclosures for a large number of hedge funds investors.

anticipated price movements.²²¹ Many hedge fund advisers earn their profits solely through the exploitation of price inefficiencies in the markets and, as a result, are “one of the significant forces in speculative markets.”²²² According to a recent survey, hedge funds are also responsible for much of the trading activity that implicates speculative strategies. These vehicles collectively control nearly 30 percent of all U.S. fixed-income trading, 55 percent of derivatives trading in the U.S. with investment-grade ratings, and 55 percent of the trading for emerging-market bonds.²²³ This survey also found that “[i]n some corners of the U.S. debt market, hedge funds practically are the market. For instance, hedge funds generated more than 80% of the trading for derivatives with high-yield ratings, and more than 85% of volume in distressed debt.”²²⁴ Arbitrage strategies are also used to exploit price inefficiencies within certain debt, securities, or currency instruments.²²⁵ In some cases, hedge funds speculate on actual events that may occur with respect to particular markets, enterprises, or transactions. This can be effectuated through short-trading and other derivative instruments.²²⁶ These speculative trading activities help advisers to guarantee positive returns irrespective of market conditions, which is often the primary reason for investing in these vehicles.²²⁷

While certain large trading positions in specific companies must be disclosed by hedge funds pursuant to rules under the Exchange Act,²²⁸ compliance with these rules does not sufficiently expose how the trading activities of such vehicles contribute to speculation. Given the growing complexities of these speculative trading strategies, which often combine a variety of instruments (some not subject to regulation by the SEC) and dynamic trading strategies to yield a positive return, the effectiveness of

221. *Definition of Speculation*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/speculation.asp>.

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

223. Craig Karmin, *Hedge Funds Do About 30% of Bond Trading, Study Says*, WALL ST. J., Aug. 30, 2007, at C3.

224. *Id.*

225. LEMKE ET AL., *supra* note 76, § 1.2.

226. *Id.*

227. *Id.*

228. Advisers that own more than 5% of publicly-traded securities must publicly disclose such acquisition. 15 U.S.C.S. § 78a et seq., Rule 13d-1 (2006). Certain qualified institutional buyers, which include many hedge fund advisers, can complete a short-form of this disclosure. 15 U.S.C.S. § 78a et seq., Rule 13g. In addition, advisers with “investment discretion over \$100 million or more of publicly traded equity securities [must] file quarterly reports disclosing these holdings and the type of investment and voting authority exercised by the manager.” LEMKE ET AL., *supra* note 76, § 7.3; 15 U.S.C.S. § 78a et seq., Rule 13f.

such reporting rules need to be re-evaluated.²²⁹ The SEC, as well as hedge fund investors and other market participants, will need access to a comprehensive view of the ongoing trading strategies utilized by such vehicles to determine the net effect that such speculative activities have on the capital markets.

For instance, numerous sources have investigated the extent to which Magnetar, a massive Chicago-based hedge fund, exacerbated the housing bubble through its speculative trading activities in complex, mortgage-backed securities.²³⁰ In late 2005, just as the housing market was beginning to deflate, Magnetar brokered deals with several banks to invest in the riskiest portion of various CDOs.²³¹ Some estimates have found that Magnetar controlled up to half of the total volume of these toxic investments.²³² Apparently, unbeknownst to the counterparties involved, the fund bet against its own trades by investing heavily into credit default swaps, which function as insurance policies, which pay out if the CDO eventually fails.²³³ Magnetar helped guarantee that the CDOs would ultimately fail by ensuring that the CDOs were comprised of only the riskiest types of assets.²³⁴ In effect, Magnetar helped to create the very CDOs that it was betting against. When these CDOs did in fact fail, Magnetar earned record returns, while their counterparties suffered enormous losses. The SEC filed charges against one such counterparty, JPMorgan Chase, for failing to tell investors that Magnetar helped to create the CDOs that it was betting against by purchasing credit default swaps.²³⁵ While Magnetar denies many of these allegations, and did not technically break any laws in brokering these deals, more research is needed to determine the extent to which these kinds of transactions harm the economy — especially in light of the new power to advertise.

229. The Dodd-Frank Act does equip the SEC with power to collect additional disclosures from both registered and exempt advisers. The Dodd-Frank Act § 404 (codified as amended at 15 U.S.C.S. § 80b-4 (2010)). These disclosures are likely designed to help the SEC identify whether certain hedge funds pose a systemic risk to the economy. *Id.* However, the SEC has neither defined systemic risk nor explained how increased speculation could be directly linked to an increase in it.

230. Stephen Gandel, *Even Housing Bears Bought Big Homes Before the Crash*, CNNMONEY (Apr. 1, 2013), <http://finance.fortune.cnn.com/2013/04/01/wall-street-housing-bubble>; Jesse Eisinger & Jake Bernstein, *The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going*, PROPUBLICA (Apr. 9, 2010), <http://www.propublica.org/article/all-the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble>.

231. Eisinger, *supra* note 230.

232. *Id.*

233. *Id.*

234. *Id.*

235. *Id.*

In addition, the price volatility that results from speculation can adversely affect investor confidence, as investors will be less likely to invest in the capital markets if the prices do not fairly represent the intrinsic value of the underlying assets. Although it is difficult to measure investor confidence and, similarly, to measure and promote policies that would improve investor confidence, many researchers in the securities regulation realm agree that preserving investor confidence is essential to the efficient functioning of the markets. A recent empirical study found that trusting individuals are more likely to buy stocks.²³⁶ In the sample analyzed by the study, a propensity to trust in others increased the probability of buying stock by 50 percent, which resulted in an increase in the value of invested stock by 3.4 percentage points.²³⁷ Professor Lynn Stout aptly stated that in order to gain this trust:

“American investors must believe that somehow the legal system constrains these individuals sufficiently that the benefits of investing outweigh the risks. They must believe that the regulators are regulating, and the watchdogs are watching. In other words, investors may not need to trust *people* before they are willing to give up their hard-earned dollars. But they must at least trust *the system*.”²³⁸

If investors believe that regulators are appropriately monitoring fraud, conflicts of interest, and other financial abuses, then they would be more willing to invest in various markets.²³⁹ Limited investor confidence can eventually constrain liquidity by pushing investors out of the capital markets into safer investments, such as treasury bonds. This can lead to decreased gains for existing stockholders, lower amounts of spending, other major cutbacks by companies, and slower economic growth.

Even still, it is difficult to predict with certainty whether the removal of the solicitation ban will lead to a significant increase in the speculative activities described above. It is too early to determine whether there is a significant correlation between advertising and speculation. Furthermore, even if speculation does in fact increase within the broader capital markets, it is equally difficult to measure the resulting harm, if any, to investor confidence and capital production. Due to this uncertainty, the SEC and/or Congress should mandate the completion of a study by the SEC's Division of Economic and Risk Analysis aimed at rigorously investigating the

236. Luigi Guiso, et al., *Trusting the Stock Market*, 63 J. FIN. 2557 (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=811545.

237. *Id.* at 2558.

238. Lynn A. Stout, *The Investor Confidence Game* 21 (UCLA Sch. of Law, Research Paper No. 02-18, 2002), available at http://ssrn.com/abstract_id=322301.

239. *Id.*

speculation that is created by the ever-growing hedge fund industry. Such a study should be completed within two years after the final solicitation rules are adopted by the SEC.

CONCLUSION

Although certain regulatory challenges remain, the removal of the solicitation ban is a step in the right direction from the perspective of hedge fund investors. As hedge funds continue to extend their reach into the portfolios of institutional investors, such as pension plans, insurance companies, and endowments, it is imperative that the industry becomes more transparent and more competitive. Removing the solicitation ban will move the industry closer to these goals, which will foster innovation, promote optimal investment decisions, and give high-quality funds the platform to effectively distinguish themselves from the pack. These resulting characteristics will inevitably make it more difficult for fraudulent advisers to induce prospective investors, as it will be more difficult for them to operate in the shadows.

If regulators can also begin the process of resolving the latent valuation challenges that still plague the industry, investors will have an even greater incentive to optimize their various hedge fund investments. Additionally, if the SEC can close the fraud loopholes presented by smaller funds through requiring all advisers who utilize advertisements to register under the Advisers Act, then investors will be further protected from fraudulent investment schemes. As the hedge fund industry continues to evolve, regulators, as well as Congress, must become more aggressive in keeping up with the changing landscape of the industry. This will entail further evaluation of increasing levels of speculation and the extent to which this speculation can harm investor confidence.

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