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Demystifying Hedge Funds: A Design Primer

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I. INTRODUCTION TO HEDGE FUNDS

Exceptions from regulation under securities, investment company, investment advisory, and tax laws define hedge fund structures and distinguish hedge funds from mutual funds. The exceptions also permit hedge funds to (i) utilize substantial economic leverage, (ii) pay their investment advisers fees that materially exceed those a mutual fund may pay its investment advisers, and (iii) prevent the United States from imposing taxes on their foreign investors or collecting a corporate level tax from the fund. Promoters of hedge funds design their funds to fit these regulatory exceptions. As exceptions change, hedge funds adjust in structure in order to remain unregulated.

Hedge funds are actively managed investments that pool investors' capital in order to acquire, own, and trade one or more of securities, commodities, and financial products. Although the first hedge fund made its appearance as early as 1949,[1] legal scholarship on hedge funds did not materialize until 1966 when the number of funds began to grow.[2] During the 1990s, hedge funds began to capture substantial investment capital from high net worth individuals.[3] Initially, some funds may have employed hedging strategies that suggested they had investment plans to protect capital,[4] but soon hedge funds evolved into high risk and, so investors hoped, high return investment vehicles for entities with excess liquidity and wealthy individuals. While some hedge funds still employ hedging strategies in part, especially market neutral funds,[5] the range of hedge fund strategies no longer relates to any fundamental hedging concept.

Because their investors and investment managers were generally very wealthy,[6] hedge funds developed mystique, as clubs that limit access to the rich and famous tend to do. Hedge funds and their managers gained the reputation of having apparent ability to wield enormous, economic influence

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[1] Douglas W. Hawes, *Hedge Funds – Investment Funds for the Rich*, 23 BUS. LAWYER 576, 577 (1966-67) (attributing first hedge fund to A.W. Jones & Company in 1949).

[2] *Id.*; *see infra* note 37.

[3] The Securities and Exchange Commission ("SEC"), without reliable data, estimated that there were approximately 400 hedge funds in 1992 and, based on the estimates of participants in an SEC roundtable on hedge funds, 6000 in 2003. SEC Staff Report, Implications of the Growth of Hedge Funds 1 (Sept. 2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

[4] A hedge is the purchase of positions that offset each other by moving in opposite value directions. Increase in the value of one position would match decrease in the value of the other. In order to make a profit, the investor would allow some spread, either value or timing, between the offsetting positions.

[5] *See* discussion of hedge fund investment strategies, *infra* Part 5.

[6] This article uses the terms "investment manager" and "investment adviser" interchangeably when referring to hedge fund advisors.

that even might threaten the financial stability of the markets.[7] But, like those clubs for the rich and famous, once allowed to enter, one discovers that what is going on inside is expensive but far more mundane than it appeared while one waited in line outside the club. Conversations inside are not more interesting; returns from hedge fund investing are sometimes better but often the same as or worse than market indices.[8]

Paucity of publicly available information about hedge funds amplified the mystique. That information scarcity resulted from limitations on the SEC's regulatory authority over hedge funds and their investment managers. Generally, neither the funds nor their managers had to register under the statutes that give the SEC regulatory oversight over mutual funds[9] and their investment advisers.[10] Except for very large funds with 500 investors or more,[11] the SEC could not demand information reporting for hedge funds' holdings and investment strategies.

Periodically, incidents occur in the hedge fund industry affecting investors or markets severely and adversely. The collapse of Long Term Capital Management in 1998 is an example of such an incident.[12] In 2004, Bayou Capital failed and its principals initially dropped from view, leaving investors with significant losses.[13] The principals later surrendered to authorities and pleaded guilty to conspiracy and fraud charges.[14] More

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[7] The collapse of Long Term Capital Management, an extremely high visibility and heavily leveraged hedge fund group, supported this view as the New York Stock Exchange and a consortium of investment banks bailed the group out to protect the integrity of the markets. *See* Roger Lowenstein, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (Random House 2000) (relating story of growth and collapse of LTCM); *see* Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management – Report of the President's Working Group on Financial Markets, by representatives from the Commission, the Treasury Department, the Federal Reserve and the Commodity Futures Trading Commission (Apr. 1999) (examining market crisis that failure of LTCM precipitated).

[8] Mark Kritzman, *Portfolio Efficiency with Performance Fees*, ECONOMICS AND PORTFOLIO STRATEGY NEWSLETTER (Feb. 1, 2007) (emphasizing asymmetry in performance fee structures [*see* discussion of performance fee structures *infra* in Part 3] as a key contributor to drag on investment returns and concluding that allocating one's portfolio to ten uncorrelated hedge funds would be likely to yield a lower return than an allocation to a series of index funds because of the high hedge fund fees). The Standard and Poor's hedge fund index for 2005 advanced only 2.3% compared with a 4.9% for the Standard and Poor's 500 index. Jenny Anderson, *By the Numbers: Hedge Funds and Half Truths*, N.Y. TIMES, Jan. 19, 2006, at C8; *see* Aaron Pressman, *Hedge Funds: The Pool is Shrinking*, BUSINESS WEEK ONLINE (Jan. 19, 2006),
http://www.businessweek.com/bwdaily/dnflash/jan2006/nf20060119_7052_db016.htm.

[9] The Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2006).

[10] The Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2006).

[11] Securities Exchange Act §12(g) requires registration of any fund if it has 500 or more owners. Securities Exchange Act of 1934, 15 U.S.C. § 78l(g) (2006).

[12] *Supra* note 7.

[13] Gretchen Morgenson, *What Really Happened at Bayou*, N.Y. TIMES, Sept. 17, 2005, at C1.

[14] *Hedge fund founder, CFO plead guilty in fraud case; Losses estimated at $450 million in Bayou scandal*, CHICAGO TRIBUNE, Sept. 30, 2005, at C3.

recently, the SEC sued the founders of HMC International for misappropriating the fund's assets to support their lifestyles.[15] And in 2003 the New York State Attorney General filed a complaint against Canary Capital Partners accusing it of illegal and fraudulent trading practices for late trading of mutual fund shares – a practice benefiting the hedge fund and harming the other investors in the mutual funds Canary late traded.[16]

Such events draw public attention to hedge funds and an occasional public outcry for regulation. However, the outcry is not from hedge fund investors nor is it grass roots. The media generate or respond to that attention and outcry with news coverage and commentary, whether the incident injures only the hedge fund's investors or threatens market stability generally. However, empirical evidence of correlation between the hedge fund trading activities and major movement in the financial markets is lacking.[17] Moreover, increased regulation of and oversight over hedge funds has not reached the top of Congress' legislative agenda. Historically, Congress failed to enact legislation regulating hedge funds. In fact, on several occasions the contrary has occurred. Congress has removed regulatory constraints from the hedge fund industry.

Contrary to Congress's easing of hedge fund regulation, the SEC recently sought, albeit unsuccessfully, to extend mandatory registration under the Investment Advisers Act of 1940 to many hedge fund managers.[18] The Court of Appeals for the D.C. Circuit invalidated the new regulations shortly following the date on which managers first had to register under the regulations.[19] The revised regulations would have altered the manner in which an investment advisor counts clients. Managers who previously did not have to register because they had fewer than fifteen clients would have had to count each investor in a hedge fund — rather than only the fund itself — as a client for purposes of the fewer than fifteen client rule.

Since the DC Circuit rejected the revisions to the client counting rule,[20] the SEC could not compel investment advisers to a limited number of

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[15] Jenny Anderson, *S.E.C. Accuses a New Jersey Hedge Fund*, N.Y. TIMES, Dec. 22, 2005, at C4.

[16] Complaint available at http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf. Late trading is the purchase after market close of a mutual fund's shares at the pre-close net asset value of the shares rather than the new after close value. The late trader captures the advance in the share price for events that occurred during the day, if any, by buying at the previous day's lower price.

[17] *See* Barry Eichengreen & Donald Mathieson, *Hedge Funds and Financial Markets: Implications for Policy* in HEDGE FUNDS AND FINANCIAL MARKET DYNAMICS, International Monetary Fund Occasional Paper 166, 2, 3 (Washington D.C. 1998).

[18] Registration Under the Advisers Act of Certain Hedge Fund Advisers, Release No. IA-2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (adding Reg. § 203(b)(3)-2 requiring investment advisers to count the underlying owners of private funds as clients).

[19] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

[20] *Id.*

funds to register. In order to assure greater transparency from investment advisers, the SEC promulgated a proposed antifraud regulation that, if adopted as a final regulation, would broaden and clarify disclosure requirements applicable to registered and unregistered investment advisers to hedge funds and other private investment pools.[21] The proposed rule renders it unlawful for an investment adviser, whether or not registered under the Investment Advisers Act to "make any untrue statement of material fact or to omit to state a material fact . . . to any investor or prospective investor in a pooled investment vehicle."[22] The proposed regulation also prohibits deceptive or manipulative practices.[23] However, the proposed regulation is broader than the general antifraud rule[24] as it applies even if the statement, omission or deceptive practice does not accompany the purchase or sale of an interest in the pooled investment vehicle or any other security.[25]

A. *Mutual Fund and Hedge Fund Risk and Liquidity Contrasted*

Hedge funds are not mysterious, although trading strategies some managers utilize are intricate and complex.[26] Hedge funds are simply pooled investments designed to avoid regulatory constraints that might inhibit profit for the investors and the investment managers. By avoiding regulation, the funds may adopt investment strategies that involve greater risk of loss than mutual funds. Concomitantly, hedge funds historically targeted investors who (i) economically could make an investment of $100,000 or more and bear the risk of its loss, if loss occurred, (ii) willingly traded greater risk for the chance to capture greater rewards, and, as outlined in the next paragraph, (iii) did not require the daily redemption liquidity of open–end mutual funds or the public trading market for closed–end funds.

Mutual funds constituting most regulated investment companies come in two varieties: open–end funds and closed–end funds. Open–end mutual funds issue and redeem shares at net asset value per share, as investors invest and disinvest.[27] Closed–end funds raise capital through offering their shares, but redeem the shares only when they dispose of their portfolio positions and do not reinvest the proceeds from the sales. Closed–end fund shares trade on exchanges or over the counter with market pricing.[28] While share price of closed–end funds theoretically ought to track net asset value per share, instead

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[21] Proposed regulation § 206(4)-8, 17 C.F.R. § 206(4)-8 (2007 proposed). SEC Release 33-8766, 72 Fed. Reg. 400 (Jan. 4, 2007).
[22] *Id.* Proposed regulation § 206(4)-8(a)(1). Compare the language of the general antifraud rule under the Exchange Act, Rule 10b-5.
[23] *Id.* Proposed regulation § 206(4)-8(a)(2).
[24] Rule 10b-5.
[25] Proposed regulation § 206(4)-8 and see discussion of enforcement action in the release document, SEC Release 33-8766, *supra* note 21, at note 26.
[26] *See infra* Part 5.
[27] 15 U.S.C. §§ 80a-4(3), 5(a)(1) (2006). No other trading market exists for the shares.
[28] *Id.* §§ 80a-4(3), 5(a)(2).

share price often lags net asset value. With respect to liquidity, open–end mutual funds generally allow daily redemption of interests and closed–end funds facilitate exchange listing and, accordingly, market trading of shares.[29] Open–end mutual funds may have as much as fifteen percent of their net assets in restricted securities and other illiquid positions.[30] Illiquid positions constitute part of the value of the fund and must not impede the fund's redemption of shares that shareholders tender.[31] The board of directors of the fund must determine the value of the illiquid positions in good faith.[32]

Hedge funds that invest in the public securities markets customarily offer their investors the opportunity to redeem their interests at least annually, but rarely more frequently than monthly. No statute requires the funds to pay the redemption amount within any specific period, but most funds seek to pay the bulk of the redemption price, often ninety percent, within ten to fifteen days of the permissible redemption date. The remainder of the price follows when the fund finally determines its net asset value for the redemption date. Depending on the risk profile of the fund, some hedge funds invest in equity positions that promise substantial long–term return, but in the interim are illiquid. Sometimes, positions become illiquid because of changes affecting the specific issuer of the securities or, more generally, market conditions.

When a fund holds such illiquid investments, the manager places them into a "side pocket," which is a separate account on the fund's books. Funds handle their side pockets in a variety of ways: (i) some funds estimate the value of side pocket positions and include a payment for them in the redemption price; (ii) more often, funds permit investors to redeem the liquid portion of their interests but retain the investor in the fund with respect to the investor's share of illiquid positions; (iii) other funds exclude side pocket value from the redemption proceeds for investors wishing to redeem from the fund before the illiquid positions are sold, so that the redeeming investor simply relinquishes any interest in the side pocket; (iv) in order to avoid harsh results, managers occasionally create a separate class of fund interests with some investors only sharing in the liquid positions in the fund's portfolio, while others, with a longer–term appetite for commitment, participate in the side pocket portion of the fund as well.[33]

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[29] *Id.* § 80a-22(e) (providing limited exceptions for extraordinary market events, prohibiting any delay in redemption of tendered shares longer than seven days).

[30] Revisions of Guidelines to Form N-1A, Release Nos. 33-6927, IC-18612, 57 Fed. Reg. 9,828 (Mar. 20, 1992).

[31] 15 U.S.C. § 80a-22(e).

[32] 15 U.S.C. § 80a-2(a)(41).

[33] Hedge funds also must isolate their positions in initial equity public offerings, so that investors in the hedge fund who are broker-dealers or affiliated with or related to broker-dealers do not participate in the gain from that portion of the hedge fund's portfolio. National Association of Securities Dealers Manual Rule 2790, http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000466.

Additionally, there are hedge funds, including venture capital and private equity funds that invest almost exclusively in private equities that are illiquid. Those funds often have their own life cycle of two to five years during which investors may not withdraw capital. Private equity funds may raise money in anticipation of identifying a single opportunity, for example purchase and turn around of a failing business.[34] While limited opportunities to withdraw invested capital characterizes closed-end mutual funds as well as certain hedge funds (and for that matter direct investment in corporations, as well), the similarity to such long term capital commitment ends there. Hedge funds lack the active secondary trading market of closed-end mutual funds although promoters sometimes will help to place an interest in the fund for an investor who wishes to dispose of one. Recent regulations requiring hedge fund managers to register as investment advisors initially motivated some managers to require a two year capital commitment for all the funds they managed so that the funds would continue to be a single client of the advisor, rather than all the owners of the fund being deemed clients for purposes of registration under the Advisers Act.[35] However, that emerging trend reversed following the judicial holding that the regulation was invalid.[36]

B. *Regulatory Frameworks and Article Goals*

While the body of scholarship on hedge funds has increased over the past several years,[37] the literature offers little by way of a simple explanation of the structures that hedge fund promoters utilize and why promoters use those structures.[38] This article will seek to fill that gap in scholarship by

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[34] Something akin to a merchant banking fund.

[35] An Advisors Act Regulation that the DC Circuit overturned in Goldstein v. SEC, *supra* note 19, exempted funds with a two-year minimum lock-up from the look through rule for counting advisory clients. Rules and Regulations, Investment Advisers Act of 1940, 17 C.F.R. § 275.203(b)(3)-2(d)(1)(ii) (2006).

[36] Goldstein v. SEC, *supra* note 19.

[37] *See*, *e.g.*, Roberta S. Karmel, *The SEC at 70: 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 (2005) (recommending greater regulatory intervention to prevent excessive speculation and avoid market crashes). *See also* Laura Edwards, Note, *Looking through the Hedges: How the SEC Justified its Decision to Require Registration of Hedge Fund Advisers*, 83 WASH. U. L. Q. 603 (2005) (explaining and discussing origin and purposes of new, but invalidated, rule governing registration of hedge fund advisers); Joseph Hellrung, Note & Comment, *Emerging Issues in Banking Regulation: Hedge Fund Regulation: Investors are Knocking at the Door, but can the SEC Clean House before Everyone Rushes In?*, 9 N.C. BANKING INST. 317 (2005) (examining new rule requiring many investment advisers to register); Rory B. O'Halloran, Comment, *An Overview and Analysis of Recent Interest in Increased Hedge Fund Regulation*, 79 TUL. L. REV. 461 (2004) (discussing regulatory proposals affecting hedge funds); Erik J Greupner, *Hedge Funds Are Headed Down-market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555 (2003) (discussing trend toward registered hedge funds and regulatory changes).

[38] William Fung & David A. Hsieh, *A Primer on Hedge Funds*, 6 J. OF EMPIRICAL FINANCE 331 (1999) (quantitatively describing hedge fund structure and performance and differing as a

describing some basic, popular hedge fund structures and explaining the regulatory planning that accounts for them.[39] The simplest answer to why promoters design hedge fund structures to avoid registration under the Investment Company Act is that hedge funds permit managers to share directly in the fund's investment gain, while mutual funds do not.[40]

The principal U.S. regulatory frameworks that might affect hedge fund investing adversely, if fund organizers fail to structure the funds correctly, are the Securities Act of 1933 (the "Securities Act"),[41] the Securities Exchange Act of 1934 (the "Exchange Act"),[42] the Investment Company Act of 1940 (the "Investment Company Act"),[43] the Investment Advisers Act of 1940 (the "Advisers Act"),[44] the Internal Revenue Code of 1986 (the "Code"),[45] and the Commodities Exchange Act (the "CEA").[46] Other regulatory structures such as state securities law[47] and the Employee Retirement Income Security Act of 1974 ("ERISA")[48] sometimes impact the operation of hedge funds.

Part 2 of this article describes the structuring of hedge funds to exempt them from regulation under the Securities Act, the Exchange Act, and the Investment Company Act. Part 3 explains how the exemption of hedge funds from regulation under the Investment Company Act enables the funds' investment advisers to avoid regulation under the Advisers Act but, more importantly, to remain free from the limitations on the fees the advisers may

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primer from this article in its very limited description of the reasons for the legal structures managers select).

[39] For readers wanting greater detail on hedge funds than this article offers, *see* Shartsis Friese LLP, Douglas L. Hammer, Carolyn S. Reiser, et al., *U.S. Regulation of Hedge Funds*, Business Law (2005).

[40] 17 C.F.R. § 275.205. *See* discussion *infra* Part 3.

[41] 15 U.S.C. §77a-aa.

[42] *Id.* §§ 78a-mm.

[43] *Id.* §§ 80a-1 to -64.

[44] *Id.* §§ 80b-1 to -21.

[45] 26 U.S.C. §§ 1-9833 (2000).

[46] 7 U.S.C. §§ 1-27f (2000). While many hedge funds trade some commodities that the Commodities Futures Trading Commission ("CFTC") regulates, this article will not address commodities regulation because commodities regulation has limited impact on the structure of hedge funds. Most hedge funds are exempt from registration under the CEA for the same structural reason that they are exempt under the Investment Advisors Act. *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763, app. E (2000); *see also* Sharon Brown-Hruska, Acting Chairman of the Commodity Futures Trading Commission, Keynote Address at the Securities Industry Association Hedge Funds Conference (Nov. 30, 2004), http://www.cftc.gov/opa/speeches04/opabrown-hruska-22.htm (arguing that commodities pools are hedge funds and that most hedge fund advisers are regulated by the CFTC, either as commodity pool operators or because they trade regulated commodities, so that SEC registration of the advisers is unnecessary).

[47] State securities laws are commonly known as Blue-Sky laws and sometimes including registration and reporting requirements even when federal law does not.

[48] Employee Retirement Income Security Act (ERISA), Pub. L. No. 93-406, 99 Stat. 829 (1974); *see* Shartsis Friese LLP, *supra* note 39, at 249-265; *infra* note 270.

collect. Part 4 identifies federal income tax rules that contribute to structural choices and result in a mixture of domestic and offshore funds to meet the needs of differing classes of investors. Part 5 discusses hedge fund strategies and the importance of leverage. Part 6 concludes by synthesizing the regulatory frameworks to an understanding of the simple fundamental nature of hedge funds and briefly explores the question of the need for additional regulation of the hedge fund industry.

II. STRUCTURING HEDGE FUNDS FOR EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACTS AND THE INVESTMENT COMPANY ACT

The Investment Company Act[49] followed upon the Securities Act[50] and the Exchange Act[51] and reflects the period of economic uncertainty in which Congress enacted it. The Investment Company Act seems to be a product of the great depression that followed the stock market crash of 1929, but adopts a somewhat different philosophical approach to investor protection than the Securities Act and the Exchange Act. The Securities Act and the Exchange Act sought to protect the investing public by assuring equal access to information for all market participants. The theory underlying disclosure is that professional market participants assimilate publicly available information and disseminate it to the investing public in more usable form. In turn, investors protect themselves if they have the material information concerning the investments. Mandatory and ongoing information disclosures achieved that goal. Under the Securities Act, an issuer of securities has to disclose a broad array of financial and operational information as a condition to entry into the public capital markets.[52] In order to prevent manipulation of the secondary market for an issuer's outstanding securities, the issuer continually must update public information concerning its operations and finances.[53] An issuer's insiders must not trade the issuer's securities if the insiders have information concerning the issuer that is not yet in the public domain.[54]

A. *Investment Company Act and Debt*

While the Investment Company Act similarly relies heavily on the disclosure philosophy to protect the public, it is more parental in its regulatory protection of investors. Along with registration, the Investment Company Act limits transactions with affiliated persons,[55] requires funds to maintain

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[49] Pub. L. No 76-768; 54 Stat. 789 (1940).
[50] Pub. L. No. 73-22; 48 Stat. 74 (1933).
[51] Pub. L. No. 73-291; 48 Stat. 881 (1934).
[52] *See* Securities Act of 1933, 15 U.S.C. § 77g (2000).
[53] Exchange Act, 15 U.S.C. § 78l (2000).
[54] *Id.* § 10(b); Exchange Act Rule, 17 C.F.R. § 240.10b-5 (2006).
[55] Investment Company Act, 15 U.S.C. §§ 80a-9, -10, -12, -17 (2006) (respectively covering affiliated persons as employees, directors, overlapping ownership, and prohibited transactions).

sufficient liquidity to redeem shares,[56] regulates corporate governance of the funds,[57] and establishes rules for pricing of the funds' portfolios.[58] Perhaps most significantly, the Investment Company Act exhibits a strong bias against debt. Section 1 of the Investment Company Act declares that:[59]

> the national public interest and the interest of investors are adversely affected
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> (7) *when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities.*[60]

The purpose of the Investment Company Act is "to mitigate and . . . eliminate" those conditions that adversely affect the public.[61] As a result of the bias against indebtedness in the Investment Company Act, a fundamental distinction between investments required to register under the Investment Company Act and investments free from the registration requirements is that tight limits on borrowing apply to registered companies. A mutual fund registered under the Investment Company Act[62] may not incur indebtedness unless it has a minimum coverage of the debt of three hundred percent.[63] Coverage of debt is the ratio of the company's net asset value to the face amount of the debt.[64] Investment companies also would be prohibited from buying securities on margin[65] and effecting short sales,[66] but the SEC has never issued the necessary regulations to implement this provision. Instead the SEC has relied on the more general debt coverage provision to limit mutual funds' indebtedness and short sales.[67] The Investment Company Act protects registered investment companies and their owners from the risk of

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[56] *Id.* § 80a-22 (covering purchase and sale of shares in the company).
[57] *See id.* § 80a-16 (covering board of directors and elections).
[58] *See id.* § 80a-22 (covering purchase and sale of shares in the company).
[59] *Id.* § 80a-1(b).
[60] Emphasis added.
[61] 15 U.S.C. § 80a-1(b). See the SEC's study of the investment company industry that laid the foundation for the Investment Company Act. SEC, Investment Trusts and Investment Companies, H.R. DOC. NO. 707 (1939); SEC, Investment Trusts and Investment Companies, H.R. DOC. NO. 70 (1939); SEC, Investment Trusts and Investment Companies, H.R. DOC. NO. 279, at 1563-1940 (1939).
[62] *See* 15 U.S.C. § 80a-8 (providing for registration of investment companies).
[63] *Id.* § 80a-18(a), -18(f) (applicable to closed-end funds and open-end funds).
[64] *Id.* § 80a-18(h).
[65] *Id.* § 80a-12(a)(1).
[66] *Id.* § 80a-12(a)(3).
[67] Guidelines for the Preparation of Form N-8B-1, 37 Fed. Reg. 12,790 (1972) (treating short sales and margin purchases as forms of indebtedness or senior securities subject to Investment Company Act § 80a-18).

debt financing of their investment portfolios[68] but simultaneously prevents them from reaping the benefits of enhanced economic returns that the leverage from borrowing might generate.[69]

In order to employ economic leverage through borrowing, organizers must structure hedge funds so that the funds do not become registered investment companies.[70] Although the Investment Company Act does not make registration expressly mandatory,[71] unregistered investment companies, unless exempt from registration,[72] may not sell securities,[73] including interests in themselves.[74] While there are classes of specifically exempt investment companies that need not register, the classifications are so narrow that they do not offer the hedge fund promoter a practical opportunity to avoid registration.[75] Therefore, their organizers select one of two basic structures for the funds that prevent the funds from fitting the investment company definition.[76] The investment company definition has an operating component,[77] a manner of offering component,[78] and an investor component.[79] If the fund avoids either the operating component or both the manner of offering and investor components, it is not an investment company. Hedge funds cannot avoid the operating component of the investment company definition, as hedge funds are or hold themselves "out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities . . . ."[80]

Hedge funds meet the manner of offering and ownership components of the exceptions to the investment company definition. Hedge funds meet the limited ownership component of the exceptions to the investment company definition. Section 80a–3(c)(1) ("section 3c1") funds[81] do so by limiting the number of the beneficial owners of their shares to one hundred.[82]

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[68] Mutual Fund Use of Derivatives, 1994 SEC No-Act. LEXIS 952 (1994) (analyzing and recommending solicitation of public comment on investment activities of registered investment companies in derivative products).
[69] *See* discussion of leverage *infra* Part 5.
[70] *See* 15 U.S.C. § 80a-18 (applying only to registered investment companies).
[71] *Id.* § 80a-8.
[72] *Id.* § 80a-6.
[73] *Id.* § 80a-2(a)(36) (defining "securities" for the Investment Company Act).
[74] *Id.* § 80a-7.
[75] *Id.* § 80a-6 (exempting possessions based investment companies that do not sell interests outside possession; funds subject to specific alternative regulatory oversight; and funds the SEC rules exempt).
[76] *Id.* § 80a-3.
[77] *Id.* § 80a-3(a)(1)(A).
[78] *Id.* § 80a-3(c).
[79] *Id.*
[80] *Id.* § 80a-3(a)(1)(A).
[81] *Id.* § 80a-3(c)(1); *see* text commencing *infra* note 109 for a more detailed description.
[82] *Id.* § 80a-3(c)(1)(A) to (B) (including some special rules for determining beneficial ownership).

Section 80a–3(c)(7) ("section 3c7") funds[83] do so by limiting their investors to qualified purchasers, who — in the case of individual investors — own at least $5 million of investments.[84]

The manner of offering test prohibits hedge funds from making or presently proposing to make a public offering of their securities.[85] The Securities Act also distinguishes public from non–public offerings of securities and whenever there is a public offering imposes registration and prospectus requirements on issuers and underwriters of securities.[86] A non–public offering,[87] which participants in the securities industry generally refer to as a private placement of securities, meets the manner of offering test for purposes of the Investment Company Act.[88]

The SEC has promulgated a non–exclusive, safe harbor definition of a private placement of securities that permits the issuer to sell its securities to an unlimited number of accredited investors and no more than thirty–five other investors.[89] Although it is not the exclusive means for qualification as a private placement,[90] the safe harbor is simple and practical for the hedge fund. The thirty–five purchasers who are not accredited investors need have no particular economic qualifications but nevertheless must meet a sophistication test.[91] The sophistication test requires that the investor have knowledge and experience in business matters or the assistance of a representative who does have that knowledge and experience.[92] If the issuer sells securities to a single unaccredited investor, the safe harbor requires the issuer to make many of the disclosures that would be necessary in connection with a registered offering.[93] On the other hand, there is no specific disclosure requirement under the safe harbor if the issuer sells to accredited investors only.[94] Accredited investors

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[83] *Id.* § 80a-3(c)(7); *see* text commencing with *infra* note 135 for discussion.
[84] *Id.* § 80a-2(a)(51); *see* text accompanying *infra* note 139 for discussion.
[85] *Id.* § 80a-3(c)(1), -3(c)(7).
[86] Securities Act of 1933, 15 U.S.C. § 77e (2006).
[87] *Id.* § 77d(2). This section is generally viewed as the private placement exemption. The statute does not use the term "private placement or offering." Rather, it exempts from registration "transactions by an issuer not involving a public offering." *Id.*
[88] *Id.* § 80a-3(c).
[89] Regulation D under the Securities Act. Securities Act Rule 17 C.F.R. §§ 230.501–230.508 (2006).
[90] 15 U.S.C. § 77d(2) reaches other issuances of securities that do not meet all the conditions of the Regulation D safe harbor. 15 U.S.C. § 77d(2) (2006); 17 C.F.R. §§ 230.501–230.508 (2006).
[91] 17 C.F.R. § 230.506(b)(2)(ii) (2006).
[92] *Id.*; 17 C.F.R. § 230.501(h) (2006) (defining purchaser representative).
[93] 17 C.F.R. § 230.502(b) (2006).
[94] *Id.*; Regulation D notes that the anti-fraud provisions do require the issuer to provide material information concerning the offering. 17 C.F.R. § 230.502(b)(1). Moreover, if proposed regulation § 206(4)-8, *supra* note 21, becomes final, it will impose broad antifraud requirements on all investment advisers, whether or not registered. As a practical matter, hedge fund promoters, on advice of their legal counsel, provide investors with a private

purportedly are those who can fend for themselves so that they do not need the protections of the Securities Act. They have adequate sophistication and economically are able to bear the loss of their investment.[95]

Given the limited number of one hundred investors a section 3c1 fund may have if it wishes to avoid the investment company definition,[96] admitting non–accredited investors diminishes the hedge fund promoter's opportunity to raise capital. As individuals need have only one million dollars of assets — and that amount even jointly with their spouses[97] — or incomes individually in excess of $200,000, or $300,000 with spouses,[98] to become accredited investors, unaccredited investors are not attractive investor candidates. They simply do not have significant capital to invest. It would be impractical for the hedge fund promoter to allocate one of a limited number of investment slots to an investor with only very modest wealth.[99] Further, the sophistication inquiry that would have been necessary in the event of a sale to an unaccredited investor is unnecessary in the case of accredited investors.[100] And the accredited investor group includes many entities as well, subject to a general $5 million asset test.[101] In addition, certain individuals who have managerial type authority with respect to the issuer also are accredited investors,[102] as their relationship to the issuer would render any disclosure unnecessary, but those investors are more suitable for section 3c7 funds since they also may invest in section 3c7 qualified purchaser funds.[103] Moreover, investment adviser regulations prohibit the investment adviser to the fund from charging investors who are not "qualified clients" a performance fee.[104] In the case of an individual, a qualified client has at least $1.5 million in assets.[105]

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placement memorandum describing and providing other information concerning the hedge fund offering, even if the fund is selling only to accredited investors.

[95] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (holding that sale of shares to rank and file employees was a public offering not a private placement).

[96] 15 U.S.C. § 80a-3(c)(1) (2006); *see* discussion *infra* in text accompanying note 109.

[97] 17 C.F.R. § 230.501(a)(5) (2006).

[98] 17 C.F.R. § 230.501(a)(6) (2006).

[99] One million dollars is not today what is was when the SEC promulgated Securities Act Rule 501(a)(5) in 1982.

Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251 (Mar. 16, 1982) (effective Apr. 15, 1982). The Dow Jones Industrial Average was under 3000 in 1986 and reached 6000 in 1996. Moreover, net worth includes the value of the equity in one's owner occupied residence.

[100] 17 C.F.R. § 230.506(b)(2)(ii) (2006).

[101] 17 C.F.R. §§ 230.501(a)(1), (3), (7) (2006).

[102] Securities Act Rule, 17 C.F.R. § 230.501(a)(4) (2006).

[103] *See* discussion of Knowledgable Employees in section 3c7 funds that otherwise have only qualified purchasers as investors *infra* in text accompanying note 151.

[104] Advisers Act Rule, 17 C.F.R. § 275.205-3(a) (2006); *see* discussion *infra* Part 3.

[105] 17 C.F.R. § 275.205-3(d) (2006).

A recently proposed rule change would redefine individual accredited investors for purposes of hedge funds and similar pooled, but unregistered, investment vehicles. Rather than income or net worth requirements, that proposal would classify an individual or the individual and his or her spouse as an accredited investor only if the individual or married couple has at least $2.5 million of investments.[106] Unlike the accredited investor definition with respect to which minimum asset requirements remained unchanged for many years, the minimum investment amount under the proposed regulation will adjust automatically to take account of inflation.[107]

B. *Section 3c1 Funds; Integration*

Until 1997 when Congress authorized section 3c7 funds,[108] hedge funds failed to meet the investment company definition by limiting themselves to one hundred United States citizens or residents as investors.[109] Investors who or which were neither citizens of nor resident in the United States were not counted toward the one hundred limit, as the Investment Company Act, like the Securities Act and the Exchange Act, does not protect or regulate the activities of non–U.S. persons except insofar as their activities affect U.S. persons or U.S. markets.[110]

Although accredited investors do not count toward the thirty–five purchaser limit for private placements, they do count toward the one hundred owner limit for exemption from the definition of investment company applicable to section 3c1 funds.[111] The rule for counting entities as beneficial owners has changed twice to make it more accommodating for hedge funds.[112] Unlike registered investment companies that may make only very limited investments in other investment companies,[113] hedge funds may invest in

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[106] 17 C.F.R. § 230.216 (2007 proposed) and proposed rule 509, 17 C.F.R. § 230.509 (2007 proposed), promulgated in SEC Release 33-8766, *supra* note 21. The proposed regulation includes a definition of investments and excludes the current investment in the fund from the computation. Compare the investment amount based classification of the qualified purchaser definitions for section 3(c)(7) funds *infra* text accompany note 139.
[107] *Id.*
[108] *See* discussion of section 3c7 funds that have only qualified purchasers as investors *infra* in text accompanying note 135.
[109] 15 U.S.C. § 80a-3(c)(1) (2006).
[110] Regulation S under § 5 of the Securities Act, 17 C.F.R. § 230.901-1001 (2006).
[111] Investment Company Act, 15 U.S.C. § 80a-3(c)(1) (2006). In measuring the cap of one hundred beneficial owners, the promoter or general partner is a beneficial owner, so that the fund in fact may admit only ninety-nine investors.
[112] *Id.* § 80a-3(c)(1)(A).
[113] *Id.* § 80a-12(d)(1) prohibits investment companies (and their controlled affiliates) from acquiring (i) more than 3 per centum of the total outstanding voting stock of another investment company; (ii) securities issued by another investment company having an aggregate value in excess of 5 per centum of the value of the total assets of the acquiring company; or (iii) securities issued by all other investment companies in which it invests having an aggregate value in excess of 10 per centum of the value of the total assets of the

other hedge funds. Currently, each entity that owns less than ten percent of the voting interests in a fund and each operating, as opposed to investing, entity without regard to investment size counts as a single investor. However, all the securities owners in the investor entity are deemed beneficial owners of the hedge fund in which the entity invests if the investor entity owns ten percent or more of the voting interests in the hedge fund and the investor entity is an investment company or would be an investment company but for the exemptions for section 3c1 and section 3c7 funds.[114] As a result, hedge funds investing in a diversified portfolio of other hedge funds[115] count as only a single investor in each fund so long as diversification limits the investor fund to less than ten percent of each fund in which it invests. On the other hand, the rule prevents layering of section 3c1 funds by admitting different investor groups into separate funds but having the separate funds invest all or most of their its assets into a single fund that conducts the group's investment activities. This article refers to such groups as "master–feeder" structures.[116] Master–feeder structures also raise integration issues that would cause multiple hedge fund offerings to be treated as a single offering.[117]

In its earlier manifestation, the security holders in any entity that owned ten percent or more of the outstanding voting securities of a fund counted as beneficial owners of the fund, even if the investment represented only a small investment for a large company.[118] In that earlier form, the provision made it difficult for new funds with limited investor capital to

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acquiring company. This restriction is explained in § 1(b) of the Investment Company Act as a pyramiding problem: "(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed. . . ." Nevertheless, with appropriate safeguards for governance, the SEC often grants no-action relief for master-feeder structures for registered investment companies. Man-Glenwood Lexington TEI, LLC and Man-Glenwood Lexington TEI, LDC, 2004 SEC No-Act. LEXIS 597 (SEC No-Act. 2004).

[114] *Id.* This article refers to funds exempt under Investment Company Act, 15 U.S.C. § 80a-3(c)(7) (2006) as "section 3(c)(7) funds." *See infra* text accompanying note 135 for discussion of requirements for § 3(c)(7) funds.

[115] Often industry participants refer to such funds as a fund of funds, a fund structure that is not generally available to registered investment companies, supra note 113, unless the investment company is sufficiently diversified that it owns no more than 3 percent of any other fund and limits its sales charge to 1.5 percent. 15 U.S.C. § 80a-12(d)(1)(F). The SEC grants no-action relief for other fund of funds structures. The France Growth Fund, Inc., 2003 SEC No-Act. LEXIS 624 (SEC No-Act. 2003) (no-action relief for investment in unregistered, offshore funds). The SEC also has proposed regulations to permit funds to invest temporary cash in money market funds. Fund of Funds Investments, 68 FR 58226 (October 8, 2003) (proposing a rule that allows unregistered funds and registered funds to investment in money market funds in excess of Investment Company Act § 80a-12(d) limits.)

[116] For a more extensive explanation of master-feeder structures, *see infra* text accompanying note 157.

[117] *See* discussion *infra* text accompanying note 121.

[118] 15 U.S.C. § 80a-3(c)(1)(A) (2006), as in effect before amendment by section 102 of the Small Business Investment Incentive Act of 1980, Pub. L. 96-477 (1980).

capture investments from large corporations. For example, a one million dollar investment by a major manufacturing corporation might be less than one percent of the corporation's assets but more than ten percent of the fund. In order to accommodate the fund industry, Congress liberalized the rule to a ten and ten test, so that a fund would have to look through the investor entity to its owners only if the entity met two conditions: (i) the investor entity owned ten percent or more of the fund and (ii) the aggregate amount of the investment and similar investments of the entity represented ten percent or more of the investor entity's total assets.[119] The current provision retains the ten percent of the fund test, (i) above, but substitutes a less inclusive test for the ten percent of assets test, (ii) above. Only if the investor entity is investment company–like must the hedge fund include the owners of the investor company as beneficial owners of the fund. The investor company is investment company–like if either investing is its primary purpose or, if the company invests but investing is not a company's primary business purpose, only if its securities investments exceed forty percent of the value of its assets.[120]

Unlike mutual funds, hedge funds were never retail products sold to all who might wish to invest in the market regardless of wealth,[121] since the minimum investment was so great. The one hundred investor cap meant that the minimum investment unit for a hedge fund had to be substantial in order for the assets in the fund to generate adequate fees to enable managers to cover operating costs. In 1996, for example, the average hedge fund investor, assuming only U.S. investors in the section 3c1 fund, would have to have an investment unit of $5 million for the hedge fund to rival the average mutual fund in assets under management.[122] Most hedge funds, however, had a smaller amount of assets under management than the average mutual fund.

Managers could increase the number of investors they admitted to the fund by marketing the fund to foreign investors. Non–U.S. investors helped fill the investment gap as they are not beneficial owners for purposes of the

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[119] 15 U.S.C. § 80a-3(c)(1)(A), before amendment by section 209(a) of the National Securities Markets Improvement Act of 1996, Title II, Investment Company Act Amendments of 1996, Pub. L. 104-290, 110 Stat. 3416 (1996).

[120] 15 U.S.C. § 80a-3(a)(1)(C).

[121] Recently, some promoters have marketed registered hedge funds as a retail product to "qualified investors," a class of investors having net worth of at least $1.5 million. *See* discussion *infra* Part 3. A proposed regulation modifying the definition of accredited investor for private investment vehicles effectively would increase the minimum net worth requirement to $2.5 million of investments (adjusted for inflation). *Supra* note 106 and accompanying text.

[122] INVESTMENT COMPANY INSTITUTE, 2005 INVESTMENT COMPANY FACT BOOK 3, 9 (2005), *available at* http://www.ici.org/pdf/2005_factbook.pdf/ (showing that in 1996, U.S. some 6,000+ mutual funds had over $3 trillion in assets. In 2004, there were approximately 8,000 active funds with over $8 trillion in assets. On average, in 1996, a mutual fund had approximately $500 million, in 2004 $1 billion under management).

Investment Company Act.[123] The presence of foreign investors added to the hedge fund mystique. Hedge funds therefore became vehicles for the international moneyed community. Wealthy foreign investors were reluctant to expose themselves to even the remote possibility of becoming subject to United States jurisdiction of any kind. As a group, they were especially eager to remain free from U.S. taxing jurisdiction.[124] Foreign investors shied from the United States limited partnerships hedge fund promoters used for their United States investors. Unlike corporations that incur an entity level tax followed by inclusion of distributions in the incomes of the corporation's owners,[125] partnerships are not taxable on their income. Rather they are transparent for tax purposes. Their partners must include their shares of the partnership's income in their separate tax computations but there is only a single tax at owner level.[126] Distributions from the partnership to the partners generally incur no further tax.[127] Foreign investors eschewed that tax transparency and wished to remain free from U.S. taxing jurisdiction. Promoters chose to base the funds they designed for their non–U.S. clients in low tax jurisdictions that have minimally intrusive regulatory systems. Caribbean and United Kingdom island jurisdictions competed for share of the investment company market.[128] While promoters frequently operated parallel funds, one a U.S. based partnership for U.S. investors and the other a foreign company for non–U.S. investors, the offshore funds did not exclude U.S. investors. Many hedge funds only operated as foreign companies that offered their securities in private placements to U.S. investors.[129]

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[123] Goodwin, Procter & Hoar, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 375 (1997) (confirming that non-U.S. persons are neither beneficial owners for section 3(c)(1) funds nor need they be qualified purchasers for section 3(c)(7) funds), and compare *supra* note 110 for Regulation S governing offshore offerings.

[124] Because the U.S. is known for the broad reach of its taxation, as it taxes its citizens and residents on their worldwide income, non-U.S. persons often become fearful of getting trapped in the U.S. taxation web.

[125] *See* I.R.C. §§ 301-385 (2000) (governing taxation of corporations that are taxable under section 11).

[126] *See id.* §§ 701-777. Note that investment companies registered under the Investment Company Act may enjoy a modified form of tax transparency by means of a corporate deduction for dividends paid to shareholders under the regulated investment company rules. *See id.* §§ 851-860L. For detail on the United States taxation of registered investment companies, hedge funds and their owners, *see infra* Part 4.

[127] I.R.C. § 731 (2000).

[128] For example, a recent visit to the Cayman Islands Monetary Authority website, http://www.cimoney.com.ky/section/regulatoryframework/sub/default.aspx?section=PD&id=666 discloses that some 2750 mutual funds (broadly defined under Cayman Island law to include private investment companies) are incorporated or registered (in order to be administered) in the Cayman Islands.

[129] For U.S. tax purposes most such funds were passive foreign investment companies (PFICs) although some formed as limited liability companies in a variety of jurisdictions and qualified as U.S. transparent for tax purposes like partnerships. *See supra* note 126 and accompanying text. This followed adoption of the so-called "check the box" regulations in late 1997. *See*

While managers could offer several funds in order to increase their capital under management, integration posed some risk to that strategy.[130] Under the SEC's integration concept, the SEC identifies factors it deems relevant in determining whether or not to treat two or more offerings as a single offering. The factors are: "whether (1) the different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, (5) the offerings are made for the same general purpose.[131] In addressing the integration question, the SEC considers the same factors relevant as it does for integrating securities offerings and adds the additional and, possibly determining, factor:

> whether an interest in one partnership would be considered materially different from an interest in a second partnership by a reasonable investor qualified to purchase both, and that relevant to this consideration would be whether the partnership had the same investment objectives, the same types of portfolio securities, and, particularly, similar portfolio risk return characteristics.[132]

If, for example, a promoter simultaneously marketed two funds with identical investment managers, investment purposes, and investor profiles, the SEC was and still is likely to consider the two funds to be a single fund with a single beneficial owner cap. By tailoring the investment strategies and markets of the various funds under the promoter's management, promoters could prevent integration of the separate funds for Investment Company Act purposes. Thus a fund might focus its activities in debt instruments rather than equities, specific industries, or specific regions or countries in order to avoid integration with other sponsored funds. Differing investor profiles also might prevent integration of funds. In one no–action response, the SEC determined that it would not integrate a fund marketed to tax exempt investors with a fund marketed to taxable investors even though the funds would have identical portfolios and managers.[133] The fund for the tax–exempt investors was based offshore and, in order to prevent realization of debt financed income that

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Treas. Reg. §§ 301.7701-2, -3 (as amended 2006), that allowed most island jurisdiction companies to elect U.S. tax transparency as if they were partnerships under subchapter K of the Code. *See* I.R.C. §§ 701-777; discussion *infra* Part 4.

[130] The SEC has not promulgated a regulation that specifies when it will deem two or more offerings to be a single offering. Guidance on integration takes the form primarily of no action letters that delineate facts and circumstances tests for integration.

[131] *See* Non-Public Offering Exemption, Securities Act, 27 Fed. Reg. 11,316 (Nov. 6, 1962).

[132] Santa Barbara Securities, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2390, at *4-5 (Mar. 8, 1983).

[133] Shoreline Fund, L.P., SEC No-Action Letter, 1994 SEC No-Act. LEXIS 517, at *6 (Apr. 11, 1994).

otherwise would be taxable to the tax exempt organizations, operated as an entity that was not transparent for United States income tax purposes.[134]

C. *Section 3c7 Funds (Qualified Purchaser Funds)*

Despite a sizable investor network that included both U.S. and non–U.S. investors, the hedge fund industry continued to lobby Congress to liberalize the one hundred investor limitation. In 1996, the industry's efforts enjoyed success as Congress not only diminished the breadth of the investor company look–through for section 3c1 funds,[135] but also effectively removed the one hundred beneficial owner barrier to the growth of the hedge fund industry with section 3c7 funds. As Regulation D permitted sales to an unlimited number of "wealthy," accredited investors because the SEC concluded that such investors did not need the full protection of the securities laws, so Congress defined a similar new category of purchaser of interests in investment pools who did not need the protections of the Investment Company Act. Differences between the underlying regulatory philosophies of the Securities Act and the Investment Company Act aside,[136] reasons for exempting offerings to accredited investors from registration requirements under the Securities Act were valid for the Investment Company Act as well. Truly wealthy folk do not need protection. Wealth suggested that the investor had the following three characteristics: (i) the ability to bear the loss from unsuccessful, high risk investments, (ii) the sophistication to understand the investment opportunity and evaluate its risks and (iii) the bargaining power to ask questions and receive answers.[137] How much wealth suffices to raise the presumption that the investor has the characteristics that eliminate the need for various protections differs from ordinary securities investments to investment company investments – possibly because unregistered investment companies generally incur significant debt.

Qualified purchasers are the accredited investors[138] of the investment company world.[139] The qualified purchaser definition uses a $5 million threshold for the exemptions it offers. The definition departs further from Regulation D by working from investments, other than the investment in the

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[134] I.R.C. § 514; *see infra* Part 4 for discussion of the treatment of debt financed income for tax exempts.
[135] *See* text accompanying *supra* note 111.
[136] *See* discussion *supra* in text accompanying note 59.
[137] SEC v. Ralston Purina Co., 246 U.S. 119, 125-26 (1953) (holding that not all employees are qualified as private placement purchasers of their employer's securities and establishing standards of (i) information access, (ii) ability to ask questions and receive answers and (iii) wherewithal to bear the risk of loss as determinants of individuals to whom non-public offerings of securities may be made).
[138] Regulation D under the Securities Act, 17 C.F.R. § 230.501(a) (2006); *see supra* text accompanying note 97.
[139] Investment Company Act, 15 U.S.C. §80a-2(a)(51)(A) (2006).

hedge fund,[140] as its base rather than aggregate assets under Regulation D. Individuals[141] and family owned entities[142] such as family limited partnerships[143] that own at least $5 million in investments are qualified purchasers. The qualified purchaser definition also embraces an investment adviser who makes investments for qualified purchasers and who manages at least $25 million. Similarly, entities that own and invest at least $25 million are qualified purchasers.[144] Without regard to investor numbers, pooled investment funds such as hedge funds owned exclusively by qualified purchasers are exempt from registration under the Investment Company Act.[145] In contrast with the Securities Act private placement safe harbor,[146] the presence of a single investor not a qualified purchaser renders the registration exemption inapplicable unless another exemption applies.[147] The SEC may modify Regulation D in response to market conditions, as it recently proposed with its special accredited investor definition for investors in private investment vehicles,[148] since Regulation D is an interpretation of a statutory principle rather than a statute itself.[149] Conversely, the one hundred beneficial owner and qualified purchaser exemptions are statutory so that their specific limitations are inflexible.

At the same time as introducing section 3c7 funds and qualified purchasers, Congress directed the SEC to promulgate regulations to allow investment in the fund by certain employees without jeopardizing the fund's exemption from the investment company definition.[150] By so doing, Congress freed up space in many section 3c1 funds and permitted some otherwise non–qualified purchasers to become investors in section 3c7 funds. The knowledgeable employee exemption was not an altogether new concept. It resembles the sophistication requirement under Regulation D. Insiders

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[140] 17 C.F.R. § 270.2a51-1(b) (defining investments for purposes of determining whether a prospective investor is a qualified purchaser under the Investment Company Act). Since the determination occurs before an investor makes the investment, the $5 million must exclude the intended investment in the section 3(c)(7) fund.
[141] 15 U.S.C. §80a-2(a)(51)(A)(i).
[142] *Id.* § 80a-2(a)(51)(A)(ii).
[143] It is interesting to note the hand of the estate planning industry in the drafting of the statute as estate planner frequently use family owned investment entities in order to capture discounts in estate value for federal estate tax purposes.
[144] 15 U.S.C. § 80a-2(a)(51)(A)(iv).
[145] *Id.* § 80a-3(c)(7).
[146] Regulation D of Securities Act Rules. 17 C.F.R. § 230.506 (2006).
[147] *See* 15 U.S.C. § 80a-3(c)(7)(A) (2006) (reading in part, "[a]ny issuer, the outstanding securities of which are owned *exclusively* by persons who, at the time of acquisition of such securities, are qualified purchasers. . . ." (emphasis added)).
[148] 17 C.F.R. §§ 230.216, 230.509 (2007 proposed), *supra* note 106.
[149] Regulation D interprets § 77d(2) of the Securities Act in light of SEC practice and decisional law, including *Ralston Purina*, 246 U.S. 119, 125-26 (1953).
[150] *See* National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416, 3436.

presumably have access to information and understand the nature and extent of the investment risk. The SEC defined the exempted employee group functionally by emphasizing participation in the fund's investment activities. So long as the employee's function is not ministerial and the employee's regular duties involve the investment activities of the fund or the management company on behalf of other funds, the employee is a "Knowledgeable Employee" whose ownership in the fund is disregarded.[151] Executives, directors, general partners and advisory board members of the fund or the management company are also "Knowledgeable Employees" under the regulation.[152]

In order to ease the conversion of existing hedge funds to section 3c7 hedge funds, the 1996 amendments to the Investment Company Act included two transitional rules. One rule permitted existing funds to qualify as section 3c7 funds while retaining investors who are not qualified purchasers but who invested in the fund on or before September 1, 1996.[153] The fund may have as many as one hundred such investors.[154] At the time the fund converts to a qualified purchaser fund, those non–qualified investors must have the opportunity to redeem all or part of their interests and receive a payment in redemption equal to the investor's proportionate share of the net value of the fund's assets in cash or in kind.[155] The rule permitting existing non–qualified purchaser investors does not freeze the size of the non–qualified purchaser's investment. Those investors who are part of the pre–September 2, 1996 group may increase their investments in the fund, decrease their investments and later increase them again without becoming excluded from that one hundred investor group.[156] On the other hand, investors who are not qualified purchasers may not invest directly in a qualified purchaser fund even if the fund has fewer than one hundred non–qualified purchaser owners but may be able to invest indirectly through a section 3c1 feeder fund.

The second transitional rule facilitates the creation of master–feeder fund structures for section 3c7 funds, but not section 3c1 funds, by including funds within the qualified purchaser definition.[157] With respect to investment in section 3c1 funds, as noted above,[158] a fund that acquires ten percent or more of a section 3c1 fund becomes transparent so that all its owners become beneficial owners of the section 3c1 fund and may cause the section 3c1 fund

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151 17 C.F.R. § 270.3c-5(a)(4) (2006).
152 *Id.*
153 15 U.S.C. § 80a-3(c)(7)(B)(i) (2006).
154 *Id.* § 80a-3(c)(7)(B).
155 *Id.* § 80a-3(c)(7)(B)(ii)((II).
156 The statute defines the group as those who "acquired any portion of the securities of such issuer on or before September 1, 1996." *Id.* § 80a-3(c)(7)(B)(i)(I). As the statute reads, an investor may remain part of the permitted group even if he or she redeems from the investment pool and later invests again.
157 *Id.* § 80a-2(a)(51)(C).
158 *Supra* note 116 and accompanying text.

to have more than one hundred beneficial owners.[159] On the other hand, a section 3c1 fund may itself become a qualified purchaser when it invests in a section 3c7 fund – even if it invests all or most of its assets in the section 3c7 fund.[160] Provided that all beneficial owners of the section 3c1 fund who acquired interests before May 1, 1996 consent to its treatment as a qualified purchaser[161] and the fund has investments of at least $25 million, the existing section 3c1 fund becomes a qualified purchaser.[162] As a qualified purchaser, it may invest in another fund restricted to qualified purchasers.

Whether or not Congress intended the result, a fund that becomes a qualified purchaser under this election may accept new investors who are not qualified purchasers so long as it continues to qualify for its exemption as a section 3c1 fund. Accordingly, a fund that has at least $25 million in assets and that may not accept new non–qualified purchaser investors if it converts to a qualified purchaser fund[163] gains the ability to accept such investors, subject to its one hundred beneficial owner limit, by becoming a feeder to a new section 3c7 fund. New qualified purchasers would buy interests in the master fund and new non–qualified purchasers enter the section 3c1 fund provided it has space under its one hundred investor limitation. Furthermore, if the section 3c1 fund is full, it might move qualified purchaser investors, who occupy beneficial owner slots in section 3c1 funds, to direct investment in the section 3c7 master fund and free up space in the section 3c1 fund for additional non–qualified purchaser investors.

After the 1996 amendments,[164] hedge funds groupings became better–defined. A fund group would have a master fund that would do all or most investing for the group and two or more feeder funds that would invest all their assets in the master fund. The master fund would be either a limited partnership or limited liability company formed under the laws of one of the states of the U.S., often Delaware. Alternatively, the master fund could be an entity based in an offshore jurisdiction that elects to be taxed as a partnership for U.S. tax purposes so that the entity allocates proportional shares of the fund's income to U.S. investors for U.S. tax purposes.[165] In the case of a U.S. entity hedge fund, an entity that the investment manager controls would be the general partner of the limited partnership or the managing member of the limited liability company, so that the manager may receive an allocation of the fund's profits.[166] One of the feeder funds that invests all its assets in the

[159] *Id.* § 80a-3(c)(1)(A).
[160] *Id.* § 80a-2(a)(51)(C).
[161] *Id.*
[162] *Id.* § 80a-2(a)(51)(A)(iv).
[163] *Supra* in text accompanying and following note 156.
[164] Investment Company Act Amendments of 1996, *supra* note 118.
[165] Treasury Reg. § 301.7701-3 (allowing various foreign eligible entities to elect partnership tax treatment under subchapter K of the Code); *see* discussion *infra* Part 4.
[166] Profit share discussed *infra* Part 3.

master fund might be a section 3c1 fund for non–qualified purchaser–investors. Like the master fund, it also would be either a limited partnership or limited liability company formed under U.S. law or an entity based in an offshore jurisdiction that elects to be taxed as a partnership for U.S. tax purposes. Its general partner or managing member is an entity that the investment manager controls. Another feeder fund might be an offshore fund that does not elect to be taxed as a partnership for U.S. tax purposes for foreign investors. The same or another offshore fund that similarly is not U.S. income tax transparent would accommodate U.S. tax exempt investors, including, subject to plan asset concerns, pension and profit sharing accounts.[167]

Section 3c7 funds have to register under the Exchange Act if they have 500 or more investors.[168] Unlike registration under the Investment Company Act that limits use of leverage and capture of incentive fees for the investment adviser, the Exchange Act does not restrict the activities of the fund or its advisers. Registration under the Exchange Act does impose reporting and public disclosure burdens on the fund and its advisers concerning its organization, financial structure, contracts and advisers.[169] The Exchange Act also requires registered issuers to report current information annually or more frequently.[170] Most hedge fund managers seek to avoid registration under the Exchange Act by limiting the overall investor count to 499.

III. HEDGE FUND ADVISERS AND INCENTIVE FEES

Investment strategies, leverage, and compliance burdens are not the only reasons that hedge fund managers seek to avoid registering the funds they manage. Also management fee restrictions are a key motivator.[171] While registration is an annoyance, the investment company itself bears the cost of reporting and compliance. Most sizable hedge funds provide their investors audited financial statements in any event [172] and funds that are transparent for U.S. tax purposes must provide investors necessary tax reporting information.[173] With limited exceptions, registration precludes the manager

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[167] *Supra* note 134 and accompanying text.
[168] Securities Exchange Act of 1934, 15 U.S.C. § 78l(g) (2006).
[169] *Id.* § 78l(b).
[170] *Id.* § 78m.
[171] 15 U.S.C. § 80b-5(a)(1) (2006) (prohibiting registered investment advisers from entering into fee arrangements that include a share of capital gains), discussed *infra* in text commencing with note 186.
[172] Increasingly, popular offshore jurisdictions like the British Virgin Island now require annual audits for hedge funds existing or administered under their laws.
[173] U.S. tax conduits file an annual return and provide their investors K-1s while non-U.S. entities generally elect conduit taxation for their U.S. investors and provide the investors substitute K-1s to enable the investors to report their shares of the fund's taxable income and loss.

from charging fees measured by the advance in the net asset value of the fund's assets.[174]

Fees for managers of hedge funds customarily consist of a combination of asset–based fees and result fees.[175] The manager may receive a fixed percentage — generally not more than one to two percent annually, with two percent becoming the model — of the assets under management without regard to investment success, and an additional amount equal to a percentage of the increase in the value of the assets under management — generally ten to twenty percent — with twenty percent probably most common.[176] Ordinarily, in master–feeder fund structures, the investment manager charges fees only at one fund level so that an investor in a feeder fund does not pay fees directly for the feeder fund and indirectly for the feeder fund's investment in the master fund. Similarly, hedge funds that invest in other hedge funds[177] charge smaller fees than do direct investment funds in order to limit, but not eliminate, the multiple fees that an investor bears through the fund layers. As explained in the following paragraphs, hedge funds sometimes compute fees separately for each investor account in order to (i) facilitate differing fee schedules for some investors, (ii) measure compensation for referring brokers and investment advisers for capital invested, and (iii) coordinate correctly with floor–based — "high water mark" — accounting for incentive fees.

Fees are negotiable, so that an offering memorandum for a hedge fund is likely to reserve the power for the investment manager to modify the stated fees for some investors. In order to avoid confrontation with the bulk of the fund's investors, hedge fund managers tend to contract separately for such fee arrangements and do not disclose their details to other investors. Investors making very large investments or investment advisers placing capital in the hedge fund for several investors may have the necessary bargaining power to negotiate more favorable fees. Brokers (and some advisers), who sell investments in the fund to their clients, may receive a continuing share of the fees the client pays to the fund. For example, a broker bringing a $1 million

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[174] 15 U.S.C. § 80b-5(a)(1). Note, however, that advisers to registered investment companies may contract to receive an asset based fee that increases or decreases "proportionately with the investment performance … in relation to the investment record of an appropriate index of securities prices. . . ." 15 U.S.C. § 80b-5(b)(2). Those fees, generally fulcrum fees, would be available to managers of mutual funds that beat the Standard and Poor's 500 Index, for example.

[175] Nomenclature and tax structure of the fees varies. Performance, incentive or result fees may take the form of an allocation of the hedge fund's profit in order to capture favorable tax characteristics, specifically long-term capital gain for the investment manager.

[176] These percentages vary considerably. Since hedge funds are not registered investment companies, only the marketplace for investment capital and competition among managers limits fees.

[177] So-called "funds of funds." *See supra* note 115 and accompanying text.

investment to a fund might receive ten to twenty basis points[178] annually from the asset–based fee (so $1 – 2,000 the first year based on a one percent asset management fee of $10,000) and an additional 5 percent of the incentive fee (another $1000 based upon a twenty percent incentive fee of $20,000 from a $100,000 increase in the account value).[179]

Fund managers frequently look to the asset–based fee for their day–to–day operating expenses and the incentive fee as their source of profit. Rarely do fund managers return any portion of incentive fees they have collected previously when assets decline in value following an incentive fee. Rather managers agree to claim subsequent incentive fees only when the value of the investor's interest exceeds the incentive fee floor or "high water mark." The floor is the highest value of that investor's interest upon which the manager previously collected an incentive fee. This floor computational method prevents the manager from collecting multiple incentive fees on cyclical increases and decreases in value in volatile markets. The floor, however, does not preclude retention of fees attributable to aberrant market spikes since the value of an investor's account is the investor's share of the net asset value of the fund without regard to whether the fund has realized any gain by disposing of positions. As is the case with mutual funds that determine daily value by marking their positions to market at market close each day, hedge funds mark their positions to market on each fee computation date in order to be able to compute the fee.[180]

To illustrate this principle: if the incentive fee is 10% of increase in an investor's account value during an accounting period and, due to a market spike on the hedge fund's positions, the value of the investor's interest increases from $10 to $50, the manager will collect an incentive fee of $4, that is 10% of the $40 increase. When the value of the investor's account declines from the succeeding market correction to $20, the investment manager does not return any part of the fee even though a refund of $3 might seem appropriate – $30 of the value increase not adhering. But while most managers do not refund the excess fee, they agree not to collect any further incentive fee until the value of the investor's interest exceeds the $50 floor.[181] To oversimplify fund accounting for the illustration, if one assumes each investor's account is separate, each investor has a separate floor. An investor who withdraws all or part of her invested funds following a decline in value eliminates her floor burden for the investment manager. For example, if the

[178] There are 100 basis points to each one percent.

[179] No standard for these fee-sharing arrangements is readily identifiable but one may assume that there is similarity in fee sharing among funds because brokers placing investments with several funds will compare arrangements and seek to capture similar and most favorable terms for all investments.

[180] *See* discussion *infra* at note 184 of illiquid positions and their value.

[181] Since $4 of the $50 is paid to the manager, some managers set the high water mark at post-incentive fee value so that the high water mark in the example is $46 rather than $50.

investor in the above example redeemed one–half of her account and received $15, the floor for the remainder of the account would be $25, rather than $50.[182]

The floor method of recapturing historical incentive fees for investors described in the previous paragraph generates somewhat perverse incentives for the investment manager. Following a decline in value after incentive fees have been collected, new investors, whose floor is the amount invested, represent the investment manager's best opportunity to receive incentive fees in the future. Following a significant decline in the value of the fund's assets, the investment manager may concentrate its efforts on raising new money in order to capture future incentive fees rather than focusing its attention on actively managing the existing portfolio to regain lost value. The more radical the decline in value, the more likely the manager is to conclude that efforts to recapture fund value will be futile. As occurred following the significant, broad market declines in 1998 and 1999, the burden of existing floors were a major factor in many investment managers' decision to liquidate some or all their hedge funds and return the remaining capital to the investors. In that way, the managers freed up their time and resources for new and more profitable ventures.[183]

Even though a fund only permits redemptions annually, the fund will pay fees to its manager more frequently, usually monthly. Consequently, the fund marks it positions to market monthly in order to compute the fee. With respect to traded securities, there is a market against which to measure value. As with mutual funds, hedge funds will value exchange traded securities at the day's close. But hedge funds may not use the same convention as mutual funds for over the counter securities and may select asked prices in order to benefit the manager. Nevertheless, funds predominately seem to use an average of bid and asked. Illiquid positions cause problems for fee collection.[184] Some managers will collect an asset fee based upon cost and defer any performance fee until sale, occasionally requiring a larger performance fee for illiquid positions than for liquid securities. Other fund documents will permit managers to estimate the value of the illiquids and collect fees accordingly. In the case of funds that hold illiquid securities only, managers invariably collect an asset–based fee measured most often by invested capital and defer collection of any performance fee until the fund disposes of its positions.

[182] Or $23. *See* note 181.
[183] Managers terminating hedge funds because of floors may have found it more difficult than earlier to raise capital for their next venture or a new hedge fund. Interestingly, hedge fund investors seem to be rather forgiving of loss in value due to broad market declines that seem to defy active portfolio management. As loss in value is a function of unusual market conditions, the investors often are willing to invest with the same manager again.
[184] *See* discussion of side pockets for illiquid positions *supra* in paragraph preceding note 34.

A. *Incentive Fee Exemptions and Registered Advisers*

The opportunity to capture substantial compensation through incentive fees may help to attract high quality and creative investment managers to the hedge fund industry. Those managers jealously guard against any fund structure that might deprive them of their ability to claim incentive fees. Historically, the requirement to register the fund under the Investment Company Act effectively prevented the investment advisor from entering into a management contract with the fund or any other client that involved the payment of a result fee or similar arrangement for the payment of incentive compensation.[185] Investment advisers[186] generally must register under the Advisers Act.[187] With certain exceptions relating primarily to the wealth of the investors to whom or which the adviser renders investment advice,[188] the Advisers Act prohibits registered and registration required investment advisers from contracting to receive compensation that includes a portion of the investment gains of their clients.[189] However, investment advisers having fewer than fifteen advisory clients (and not holding themselves out to the public generally as investment advisers) are exempt from registration[190] unless one or more of the clients is an investment company.[191]

Historically, investment advisers to section 3c1 funds relied on the fewer than fifteen client exemption from investment adviser registration in order to capture incentive fees.[192] The advisers limited the number of funds they advised to fourteen, treating each advised fund, and not the underlying owners of the fund, as a single client.[193] Although a section 3c1 fund was not an investment company under the Advisers Act,[194] it was a client, and no general exception to the restriction on incentive fees existed for section 3c1

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[185] 15 U.S.C. § 80b-5(a) (2006).

[186] *Id.* § 80b-2(a)(11) (defining term "investment adviser" broadly to encompass any person "who, for compensation, engages in the business of advising others,…, as to the value of securities or as to the advisability of investing in . . . securities."

[187] *Id.* § 80b-3. Investment advisers who are subject to state regulation, do not advise a registered investment company and have less than $25 million under management may not register under the Advisers Act. *Id.* § 80b-3(a).

[188] Advisers Act Rule, 17 C.F.R. § 275.205-3 (2006); *see* discussion *infra* in text commencing with note 199.

[189] *Id.* § 275.205(a)(1) prohibits investment advisory contracts that provide "for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client. . ."

[190] 15 U.S.C. § 80b-3(a)(3) (2006).

[191] *Id.* § 80b-2(a)(12) incorporates the definition of investment company under the Investment Company Act, that is, a company required to be registered under the Investment Company Act. *Id.* § 80b-2(a)(12).

[192] *Id.* § 80b-2(a)(3).

[193] Advisers Act Rule, 15 C.F.R. § 275.203(b)(3)-1(a)(2) (2006) (treating entity as single client if advisor renders advice to entity based on entity's investment objectives).

[194] 15 U.S.C. § 80b-2(a)(12).

funds.[195] Incentive fees were not a problem for section 3c7 funds, as an express statutory exemption permits incentive arrangements for those funds.[196] After 1996, a registered investment adviser (with or without more than fourteen advisory clients) could avoid the incentive fee limit by charging the incentive fee at the section 3c7 master fund level only. Similarly, offshore funds that do not have U.S. residents as beneficial owners are exempt from the incentive fee limit.[197]

B. *Registered Hedge Funds; Qualified Clients*

Some hedge funds began to resemble the more retail mutual funds as early as 1985 when the SEC, exercising its rulemaking authority,[198] permitted incentive fee contracts for moderately wealthy investors.[199] Under the new rule, registered investment advisers were permitted to enter into incentive fee arrangements with clients who had a minimum investment with the registered adviser of $500,000 or $1 million of net worth.[200] In the case of a private[201] or registered investment company,[202] the exception to the incentive fee limitation applied only if all the owners of the company met the $1 million net asset standard.[203] The 1985 rule imposed a one–year minimum investment requirement for incentive fees and restricted the computational method to include unrealized losses whenever unrealized gains were included.[204] In addition, the rule mandated specific disclosures[205] and imposed an arm's length standard on the contract.[206]

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[195] *Id.* § 80b-5(a).
[196] *Id.* § 80b-5(b)(4).
[197] *Id.* § 80b-5(b)(5).
[198] *Id.* § 80b-5(e).
[199] The SEC promulgated Advisers Act Rule 205-3 in Release No. IA 996, Exemption To Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account. Investment Company Act Release No. 996, 50 Fed. Reg. 48,556 (Nov. 26, 1985).
[200] Advisers Act Rule, 17 C.F.R. 275.205-3(b)(1) (1985). The 1985 definition overlapped the accredited investor definition for individuals under Securities Act Rule 501(a)(5), *supra* note 97, and accompanying text, with respect to the asset test but did not include the alternative income test of Securities Act Rule § 501(a)(6). For companies, however, the $1 million net asset test was far less demanding than the $5 million test for accredited investors. Securities Act Rule, 17 C.F.R. § 501(a)(3) (2006).
[201] While section 3(c)(1) funds limited to 100 investors were not investment companies under the Investment Company Act, absent an exemption, Advisers Act section 205 prevented registered investment advisers from charging incentive fees even to those funds.
[202] Registration of a fund under Investment Company Act § 8 permitted sale of interests to more than 100 investors, a product suitable for retail.
[203] Advisers Act Rule, 17 C.F.R. § 275.205-3(b)(2) (1985).
[204] *Id.* § 275.205-3(c) (1985).
[205] *Id.* § 275.205-3(d) (1985).
[206] *Id.* § 275.205-3(e) (1985) (requiring adviser believe contract to represent arm's length arrangement).

The SEC modified the incentive fee rule substantially in 1998, tightening the investor qualifications but removing the various contractual restrictions.[207] Instead of the $1 million net asset test, the revised rule defined "qualified clients" to whom a registered advisor might charge an incentive fee to those clients who either have $750,000 under the adviser's management, have net assets of $1.5 million, are qualified purchasers[208] or are knowledgeable employees of the investment adviser, that is certain of the investment adviser's insiders – managers, officers, discretionary traders, for example.[209] The SEC explained in its issuing release that the increase from $1 million to $1.5 reflects adjustment for inflation.[210] The 1998 revisions no longer required that all investors in a fund that entered into an incentive fee contract be qualified clients, so long as those who were not qualified clients were not subject to the incentive fee.[211]

Although statistics on the volume of qualified client funds are not available separately from general statistics on registered investment companies, it is likely that the number of registered investment companies charging incentive fees and marketed to qualified clients grew rapidly after 1998. Unlike section 3c1 and 3c7 funds that are exempt from registration,[212] registered funds may not trade securities short unless the trades are covered with the fund's own portfolio.[213] Similarly, leveraging is not an available investment strategy as all registered funds must have three hundred percent asset coverage for their debt.[214] While some participants in the industry refer to qualified client funds as registered hedge funds, those funds do not fit cleanly within a hedge fund definition. They resemble hedge funds with respect to advisory fees and tend to engage in a broader and riskier array of trading strategies than do mutual funds generally but the resemblance may end

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[207] Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account Release No. IA-1731, 63 Fed. Reg. 39,022 (July 21, 1998).

[208] Including qualified purchasers may seems unnecessary as anyone with $5 million of investments is likely to have net worth of at least $1.5 million but the $5 million investments requirement takes into account only acquisition indebtedness and not other indebtedness of the qualified purchaser.

[209] 17 C.F.R. § 275.205-3(d)(1) (1998).

[210] Part II.B.1 of Advisers Act Release No. IA-1731, notes that 1 million 1985 dollars was approximately the same as 1.5 million 1998 dollars. The SEC, however, has not increased the $1 million definition for accredited investor commensurately. Securities Act Rule, 17 C.F.R. § 230.501(a)(5) (2006); *supra* note 207. And note the proposed change to the accredited investor definition for investors in private investment vehicles that includes an internal inflation adjustment. 17 C.F.R. §§ 230.216, 230.509 (2007 proposed), *supra* note 106.

[211] Advisers Act Rule, 17 C.F.R. § 275.205-3(b) (1998).

[212] 15 U.S.C. § 80a-3(c).

[213] Guidelines for the Preparation of Form N-8B-1, 37 Fed. Reg. 12,790 (June 9, 1972) (treating short sales and margin purchases as forms of indebtedness or senior securities subject to Investment Company Act section 18); *supra* note 67.

[214] 15 U.S.C. § 80a-18(a)(1)(A).

there. Incentive fees may be a function of the reputation of the investment adviser who exacts the incentive for making its "stock picking" services available to moderately wealthy investors.

Emphasizing the growing importance of hedge funds to the efficient functioning of the U.S. capital markets and, in light of that importance, the SEC's need to monitor funds and collect information concerning them in order to protect the investing public, the SEC sought to modify exceptions to investment adviser registration to compel advisers to register and report many of their activities and the activities of the funds they advise.[215] The modification to the registration requirement was short lived. The Court of Appeals of the D.C. circuit struck down the regulation within a few months following the date it became effective.[216] If the regulation had been valid, it would have modified the definition of client for purposes of the fourteen–client rule.[217] Advisers to section 3c1 and 3c7 funds would have counted the underlying owners of the section 3c1 and 3c7 funds as clients, including the owners of any fund investing in the client fund.[218] It is unlikely that any hedge fund manager would continue to have fewer than fifteen clients under that revised rule. With the rule now invalidated, entities, including limited partnerships, count as a single client without regard to the number of their underlying owners, if the adviser renders advice with respect to the entity's investment objectives and not the entity's owners.[219]

IV. TAXATION, RICS, REITS, AND HEDGE FUND STRUCTURE

Mutual funds and real estate investment trusts are partially federal income tax transparent.[220] The entities elect to have their income taxed to their shareholders, rather than to the pooled investing entity itself. Insofar as losses offset the entity's own income in a taxable year, tax transparency runs to losses as well as income, but transparency is not available for net loss as it is for net gain. Both regulated investment companies – mutual funds

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[215] Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Company Act Release No. IA-2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004), *supra* note 18. Registered adviser must adopt policies and procedures and designate a compliance officer. The SEC estimated the cost to register, including legal and accounting fees, to be approximately $50,000. *Id.* at 72064 n. 112. Registered investment advisers must complete a disclosure of concerning personnel, activities and assets under management, as well as their policies and procedures to assure compliance with the Advisers Act and the securities laws. *See* 17 C.F.R. § 275.279.1 (2006); Form ADV, *available at* http://www.sec.gov/about/forms/formadv.pdf.

[216] Goldstein v. SEC, 451 F.3d 873, *supra* note 19.

[217] 15 U.S.C. § 80b-3(b)(3) (2006) (exempting advisors with fewer than fifteen clients from registering under Advisers Act).

[218] Advisers Act Rule, 17 C.F.R. § 275.203(b)(3)-2 (2006).

[219] *Id.* § 275.203(a)(2).

[220] I.R.C. § 851-55 (2006) (governing most registered investment pools).

(RICs)[221] – and real estate investment trusts (REITs)[222] must distribute at least ninety percent of their taxable income, other than capital gain income, to their shareholders annually in order to escape entity level tax on their incomes.[223] A corporate tax burdens all income, whether or not distributed, if the entity fails to distribute ninety percent of its ordinary income.[224] If the entity passes the ninety percent test, the corporate tax reaches only that portion of income that the entity does not distribute to its shareholders.[225] The entity–level tax mechanism that protects the investment entity from the corporate tax is a deduction for dividends the entity pays to its shareholders.[226] As such, RICs or REITs may claim no dividends paid deduction for undistributed income. Generally, RICs and REITs distribute substantially all their capital gain income and the remainder of their ordinary income to secure full tax transparency with respect to income.

The dividend to shareholders generally preserves the character of the income to the entity. Capital gain dividends, to the extent of a RIC's or REIT's net capital gain,[227] are long term capital gains to shareholders.[228] Dividends a RIC pays out of qualifying dividends it receives are qualifying dividends to the shareholders[229] and exempt interest dividends are exempt interest income to the shareholders.[230] Moreover, dividends the entity pays after the close of its taxable year revert to the taxable year, as long as the RIC or REIT declares the dividend before it timely files its tax return.[231] In order to avoid having to make actual cash distributions to all shareholders to capture

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[221] *Id.* § 851(a) (defining regulated investment company to include registered investment companies under Investment Company Act and other entities).
[222] *Id.* § 856 (defining REITs).
[223] *Id.* §§ 852, 857 (2006).
[224] I.R.C. § 852(b)(1) imposes a corporate tax under I.R.C. § 11 for RICs. I.R.C. § 852(b)(2)(d) provides a deduction for dividends the RIC pays to its shareholders, and I.R.C. § 852(b)(3)(A),(B) imposes a corporate tax on the RIC's capital gain but provides a deduction for capital gain dividends the RIC pays to its shareholders. I.R.C. § 857(b)(1), (2)(B) and (3) combined provide the same tax treatment for REITs.
[225] *Id.*
[226] *Id.* §§ 852(b)(2)(D), 852(b)(3)(B) (RIC deductions for ordinary and capital gain dividends); *Id.* §§ 857(b)(2)(B), 857(b)(3)(B) (REIT deductions); *Id.* § 561 (defining the dividends paid deduction).
[227] *Id.* § 1222(11) (defining net capital gain as the excess of net long term capital gain over net short term capital loss).
[228] *Id.* §§ 852(b)(3)(B), 857(b)(3)(B). Note, however, that net short term capital gain as defined in I.R.C. § 1222(5) becomes an ordinary income dividend to the shareholders that is not a qualifying dividend.
[229] *Id.* §§ 854(b)(1)(B), 857(c)(2). Qualifying dividends under I.R.C. § 1(h)(11)(B) are dividends received that qualified for the reduced rate of tax under I.R.C. § 1(h)(11).
[230] *Id.* § 852(b)(5)(B).
[231] *Id.* §§ 855, 858. I.R.C. §860 permits a deficiency dividend and deduction to eliminate the entity level tax, but not the interest on any deficiency, if there is an adjustment in tax liability from settlement with the Internal Revenue Service or court proceeding.

the dividends paid deduction,[232] RICs and REITs offer dividend reinvestment programs under which the shareholder may elect to have the fund automatically reinvest dividends otherwise payable. Reinvestment programs are simple, generally requiring only checking a box at the time of investment for a shareholder to participate. As RICs and REITs generally offer daily liquidity, a shareholder may redeem all or part of the shareholder's interest at any time to receive cash.

Real estate mortgage investment conduits ("REMICs")[233] and, from 1997 to 2004, financial asset securitization investment trusts ("FASITs")[234] facilitated pooling of various debt instruments by treating the holders of the interests as direct owners of the underlying asset of the entity. Accordingly, income of a REMIC or continuing FASIT is taxable to the holder of an interest as if the REMIC or FASIT were a tax nothing.[235]

While Congress has defined specific, transparent tax regimes for RICs, REITs, REMICs, and FASITs, domestic hedge funds achieve federal income tax transparency by taking limited partnership form.[236] Offshore hedge funds either elect partnership tax status for U.S. tax purposes[237] or agree to provide sufficient information to enable their U.S. investors to pay tax currently on their shares of the fund's income through a qualifying electing fund shareholder's election.[238] Alternatively, if their U.S. investors are exclusively organizations that are exempt from federal income taxation,[239] offshore hedge funds may elect where necessary to be associations taxable as corporations for U.S. purposes.[240] The following paragraphs elaborate upon these choices.

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[232] *Id.* § 561 defines dividends paid.
[233] *Id.* §§ 860(a)-(g).
[234] I.R.C. §860(h)-(l) (1978), *repealed by* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 835, 188 Stat. 1418 (2004).
[235] Compare disregarded entities such as qualified subchapter S subsidiaries under I.R.C. § 1361(b)(3) and single owner limited liability companies under Treas. Reg. § 301.7701-3(b)(1)(ii), -3(b)(2)(i)(C).
[236] All states provide for limited partnership entities. Subchapter K of the Code, I.R.C. §701-77 (2006), governs the taxation of partnerships and other entities, including limited liability companies, that are taxed as partnerships under the Code.
[237] Treas. Reg. § 301.7701-3 (2006) (assigning partnership tax status to various business entities and permitting entities classified as tax partnerships to elect corporate tax treatment and some entities otherwise classified as associations taxable as corporations to elect partnership tax status – commonly referred to as the "check-the-box" rule).
[238] I.R.C. § 1295 (2006) (providing for the election); *Id.* § 1292 (2006) (defining the effect of the qualified electing fund election).
[239] *Id.* § 501(a).
[240] Treas. Reg. § 301.7701-2(b)(8) (2006) classifies many foreign entities as corporations and Treas. Reg. § 301.7701-3(b)(2) (2006) presumptively classifies foreign entities as partnerships only when at least one member does not have limited liability. Those partnership classified entities may elect to be associations taxable as corporations for U.S. tax purposes under Treas. Reg. § 301.7701-3(c)(1) (2006).

A. *Taxable Investors*

Investment partnerships, whether limited or general partnerships, are fully transparent for federal income tax purposes.[241] Under the partnership tax rules,[242] the partnership allocates its net income or loss and its separately stated items of income and deduction among its partners[243] according to the partnership agreement.[244] Like RICs and REITS, tax transparency preserves the character of partnership tax items, as the partners include their shares of those items in their individual income computation.[245] Items such as capital gain,[246] both long and short term,[247] dividends,[248] and tax exempt interest[249] that are taxed to individuals and some entities at a lower rate of tax than ordinary income retain their preferred tax character as they pass through the partnership to the partners. Unlike RICs and REITs, transparency for partnerships extends to losses as well, so that partners may deduct their shares of net partnership loss and capital losses[250] to the extent of the partner's adjusted basis in his or her partnership interest.[251]

Since hedge funds actively trade securities and other positions, rather than passively investing in and holding positions for appreciation, many funds report their operating expenses as expenses from the active conduct of a trade or business.[252] As ordinary and necessary trade or business expenses,[253] rather than investment expenses,[254] the investors' shares of those expenses are not

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[241] I.R.C. § 7701(a)(2) (2006) (defining partnership and not distinguishing among general, limited and limited liability partnerships). Liability sharing regulations under Treas. Reg. §1.752-2(f) (2006) for example, treat limited and general partners differently from one another.

[242] *See supra* note 236.

[243] A partnership computes its income in much the same manner as an individual. I.R.C. § 703 (2006). The partnership, however, separately states various items of income or deduction that, when partners with differing tax characteristics take their shares into account, tax outcomes will differ. I.R.C. § 702(a) (2006).

[244] I.R.C. § 704(a) (2006).

[245] I.R.C. § 702(b), (c) (2006).

[246] Under I.R.C. § 1(h), individuals pay a lower rate of tax on long-term capital gain, as defined in I.R.C. § 1222(2), than they do on their ordinary income while corporations do not.

[247] RIC and REIT distributions do not preserve the character of short term capital gain, *supra* note 228.

[248] Corporations may claim a dividends received deduction when they receive dividends from other corporations under I.R.C. § 243. Individuals, currently, pay a lower than ordinary income rate of tax on many dividends under I.R.C. § 1(h)(11). I.R.C. §§ 1(h)(11), 243 (2006).

[249] *Id.* § 103 (exempting interest on state and local obligations from federal income tax).

[250] *Id.* § 702(a).

[251] *Id.* § 704(d) (limiting partner's deductible loss to partner's partnership interest adjusted basis but allowing unlimited carry forward of any non-deductible loss).

[252] Comm'r v. Groetzinger, 480 U.S. 23 (1987) (holding that gambling constitutes a trade or business when the activity is sufficiently regular and businesslike). Hedge funds managers distinguish the fund's activities from passive investing because of the active manner in which they trade.

[253] I.R.C. § 162(a).

[254] *Id.* § 212.

subject to the 2% floor on miscellaneous itemized deductions.[255] As a result of this reporting position, a fund might allocate to an investor both long term capital gain and an ordinary deduction in the same year, representing the ideal tax combination of income as long term capital gain and expenses as ordinary deductions. However, active trading means short holding periods for positions and, accordingly, short– rather than long–term capital gain. A special tax regime governs any commodities positions the hedge fund holds,[256] including regulated futures contracts, forward contracts, and certain equity options. The statute requires the fund to determine the fair market value of those positions at the close of the taxable year under a procedure of "marking to market" and to include the unrealized gain or loss in the positions in the fund's gross income, even though the fund has not sold or exchanged the positions.[257] Under that statute, that gain or loss is sixty percent long term capital gain and forty percent short term capital gain without regard to the actual holding period of the position.[258]

Hedge fund managers generally adopt limited partnership form for their domestic funds and elect partnership tax status for their offshore funds that have taxable U.S. persons as investors.[259] In addition to enabling the managers to control the fund by restricting the voting rights of the investors,[260] limited partnerships and offshore companies taxed as partnerships permit (i) the fund to have multiple classes of interests with different fees and allocations of income and (ii) the manager to receive performance allocations of the partnership's income rather than fees. In

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[255] *Id.* § 67 (limiting deductibility of certain items to amount by which all such items exceed 2% of taxpayer's adjusted gross income). The Internal Revenue Service may challenge this reporting position on deductibility but does not seem to have done so as yet. On the other hand, a partnership that takes the position that its trading activities constitute a trade or business may find itself unable to prevent reducing its basis in its assets under I.R.C. § 743, as amended by § 833(b) of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 188 Stat. 1418 (2004), when there is a sale of a partnership interest at a loss because an electing investment partnership can never have been engage in a trade or business. I.R.C. § 743(e)(6) (2006). Rarely do hedge fund partnership interests trade, however, as the partnership generally redeems the interest of a departing partner, so that the opportunity to prevent reduction in basis is relatively insignificant. The statute applicable to redemptions of interests offers no comparable opportunity to prevent basis reduction. *Id.* § 734.

[256] I.R.C. § 1256.

[257] *Id.* Generally, a taxpayer realizes and recognizes gain or loss and includes the gain or loss in gross income only when the taxpayer sells property or exchanges property for other property. I.R.C. § 1001(a), (c) (2006). The author has argued elsewhere that the realization requirement embodied in I.R.C. § 1001 is a constitutional requirement so that I.R.C. § 1256 is unconstitutional. Henry Ordower, *Revisiting Realization — Accretion Taxation, the Constitution,* Macomber*, and Mark to Market*, 13 VIRGINIA TAX REV. 1 (1993).

[258] I.R.C. § 1256(a) (2006).

[259] Treas. Reg. § 301.7701-3(b)(2), (c).

[260] Limited partners under the revised uniform limited partnership act generally have very limited or no voting rights, while foreign companies may issue non-voting shares to investors and voting shares to the manager.

addition, offshore companies that make the U.S. partnership election may admit both U.S. and foreign investors, without providing information to the U.S. concerning the foreign investors.[261]

The partnership agreement (or governing instrument in the case of the offshore electing company) controls the allocations of partnership items of income and deduction.[262] Unless the allocations do not have substantial economic effect,[263] the allocations under the partnership agreement of items of income and deductions for expenses may differ from partner to partner without regard to the partner's capital contribution to the partnership. Profit allocations increase a partner's capital account balance and allocations of deduction or loss decrease a partner's capital account balance. As long as distributions of money will follow capital account balances when a partner redeems a partnership interest and when the partnership terminates, the allocation has the necessary economic effect to meet tax requirements.[264] Investment partnerships like hedge funds customarily determine the values of their investment positions periodically, usually monthly, and allocate changes in value from the previous period among the partners. Advance in value increases the partners' capital accounts and retreat in value decreases the partners' capital accounts.[265] Allocations of tax inclusions and deductions that might differ from the book allocations in amount follow the book allocations although hedge funds, if permitted, may make a general mark–to–market inclusion election, so that they may avoid disparity between book and tax allocations.[266] The election may not be available to the many hedge funds

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[261] Domestic partnerships must file Form 1065, partnership information return of income, to which it attaches a schedule K-1 for each partner. Foreign electing entities, on the other hand, need not file a U.S. partnership return but must provide to their U.S. owners, the same information those owners would have received on a domestic K-1 so that they may correctly report their shares of the entity's tax items.

[262] I.R.C. § 704(a) (2006).

[263] I.R.C. § 704(b). The intricate Treas. Reg. §1.704-1, -2 (2006) seeks to define and limit the concept of substantial economic effect. In the case of a hedge fund, the income and expense allocations define the amount of cash that the partner ultimately will receive from the partnership and, therefore, have substantial economic effect.

[264] Treasury reg. § 1.704-1(b)(2)(ii) (2006). The allocations also must be "substantial" under treasury reg. § 1.704-1(b)(2)(ii), a somewhat more complex concept than economic effect. To oversimplify the concept, if the allocations are not arbitrary but are a function of an economic, rather than pure tax driven arrange, the allocations meet the substantiality part of the test.

[265] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(iv) (2006) (allowing revaluations of the property of partnership that trade securities, commodities, and other related positions like derivative products according to industry accounting standards).

[266] I.R.C. § 475(e) (2006) permits taxpayers that trade securities to elect mark to market accounting under which they determine the fair market value of their positions at the close of the taxable year and include the gain and loss in those positions in income as if they had sold the positions for their fair market value at the close of the taxable year.

that hold large numbers or value amounts of illiquid positions that they cannot mark to market with any significant level of comfort.[267]

B. *Manager's Compensation in Partnerships*

Rather than receiving a cash payment or an interest in the partnership as a fee that would be taxable as ordinary income to the investment manager/general partner, the partnership allocates part of its income and book gain to the general partner. Specifically, as the partnership re–determines the value of its positions, in the case of a twenty percent performance share, for example, the partnership specially allocates twenty percent of the book gain to the general partner's capital account. On the other hand, the partnership allocates book losses among the partners, including the general partner, in proportion to the partners' capital account balances. Accordingly, the general partner receives an allocation of twenty percent of profit but bears only a proportional share of loss.

Since capital accounts determine how much cash a partner will receive on liquidation of the partnership, the manager, as general partner, has an increasing share in the partnership's capital. If the manager wishes to convert that interest to cash, the manager may cause the partnership to redeem part of the manager's interest in the partnership. Rather than the special allocation being an ordinary income fee to the manager, the allocation is made up of the same types of income as the partnership realizes, some or all of which may be long–term capital gain and dividends that may be taxable at lower than ordinary income rates in the hands of the general partner.[268] General partners usually are themselves tax transparent entities – limited liability companies and S corporations, so that the general partner's share of the hedge fund partnership's income is taxable to the general partner's individual owners. As individuals the owners may capture the lower dividend and long term capital gain rates.

For example, assume the fund has a general partner with a zero capital contribution and a twenty percent performance allocation and a limited partner who invests $100. The partnership evaluates its positions at the close of the month and determines that there is a gain of $10. The partnership allocates $2 to the general partner who now has a capital account of $2 and $8 to the limited partner who now has a capital account of $108. Since a liquidation of the partnership following the allocation of that book gain for $110 would result in a distribution of liquidation proceeds of $108 to the limited partner and $2 to the general partner, the allocation has economic effect for partnership tax purposes.[269] If no liquidation occurs and, in the next month,

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[267] I.R.C. § 475 is only available if the taxpayer can determine the value of its positions because of an available trading market. *See* discussion of illiquid side pocket positions, *supra* in Part 1.

[268] *Supra* note 243 discussing I.R.C.§ 1(h).

[269] Treas. Reg. § 1.704-1(b)(2)(ii).

the partnership positions decline $10 in value, the partnership allocates 2/110 of the loss or $0.18 to the general partner and the remainder to the limited partner — $9.82. Capital account balances are now $1.82 and $98.18 respectively. Capital accounts define the partners' proportional shares for the next month's allocation of further loss and deduction, as well as income until the limited partner's capital account regains the performance allocation floor.[270] Unless the limited partner withdraws or the partnership liquidates, the general partner will receive no further performance allocation until the limited partner's capital account reaches $108 again. For example, if, in the third month, the partnership's positions advance $10 again, the partnership would allocate the first $9.82 to the limited partner to restore the floor. The remaining $0.82, the partnership would allocate $0.16 to the general partner (20%) and the remainder to the limited partner.

The allocations that the previous paragraph describes are book, rather than tax, items.[271] The partnership allocates the increase in value based upon a book adjustment of its positions before it takes taxable income or loss into account. Any corresponding taxable inclusion or deduction must await the disposition of the positions, the change in the value of which generated the special allocation and adjustments to the partners' capital account balances. If in the first example, the partnership's year closed following the first $10 gain, and the partnership recognized $5 long term capital gain on its positions for the year, the partnership would allocate that taxable gain $1 to the general partner and $4 to the limited partner in order to eliminate the disparity between book and tax that the revaluation of the partnership's positions created.[272] The partnership initially would allocate all its ordinary tax deductible expenses for the year to the limited partner until the general partner received its first special allocation that gave it a capital account. Then the partnership would allocate tax items between the partners in proportion to those capital account balances.[273]

Taxation of the general partner who receives a performance allocation from hedge or private equity funds recently has become a topic of discussion in the press,[274] among members of Congress[275] and in the academic

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270 *See* discussion of the floor or "high water mark," *supra* Part 3 note 180 and accompanying text.

271 Treas. Reg. § 1.704-1(b)(2)(iv) (2006) (providing rules for maintenance of capital accounts under the regulations).

272 Treas. Reg. § 1.704-1(b)(2)(iv)(r)(4)(i) (2006) (applying I.R.C. § 704(c) principles to readjustments of capital that create book-tax disparity).

273 I.R.C. § 706(d) (requiring that partnerships must allocate income and loss to take changes in interests during the taxable year into account).

274 *Editorial: Taxing Private Equity*, N.Y. TIMES, Apr. 2, 2007, *available at* http://www.nytimes.com/2007/04/02/opinion/02mon1.html (arguing that the general partner who receives a carried interest in private equity funds should be taxable on the interest as ordinary income, rather than capital gain, and noting that Congress has begun to address the

literature.[276] Those sources suggest that Congress may modify the Code to tax those performance allocations as ordinary compensation income, rather than a share of partnership income including capital gain. As noted above,[277] the partnership currently allocates book income, including unrealized asset appreciation that is not yet taxable (and may never become taxable if the assets depreciate in value again before the partnership sells them), among all the partners. As part of that book income allocation, the general partner receives the twenty percent performance allocation. When the partnership realizes taxable income of all types, especially capital gain, and from all sources, it allocates that taxable income among the partners, including the general partner, according to the partners' distributive shares. Those distributive shares take the performance allocation of book income to the general partner into account.[278]

The recent literature argues that taxing performance allocations as ordinary compensation income is appropriate for hedge and private equity fund managers.[279] Taxing as ordinary income, however, will necessitate a change in the relatively longstanding rules governing the receipt of a partnership profits interest for services.[280] Those rules emanate from the government's concession on timing and valuation issues following unsuccessful litigation in Campbell v. Commissioner.[281] While that decision concluded that the interest was taxable if subject to valuation, the court held that the interest had no value when the taxpayer received it.[282] The outcome of non–taxability allowed taxpayers in many cases, not limited to hedge and private equity funds, to convert what otherwise would be ordinary income from their services into income from property, often capital gain.[283]

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issue. The editorial implies, mistakenly, that the capital gain is all long term taxable at a maximum 15% rate.).

[275] *Id.*

[276] Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, Colorado Law, Legal Studies Research Paper Series, Working Paper Number 06-27 (Revised Mar. 11, 2007) (referred to in the New York Time editorial *supra* note 274 and arguing that the current structure of taxing partnership profits interests for services permits the conversion of income from human capital into capital gain and arguing that altering that tax treatment would be a compelling and justifiable tax change).

[277] Text accompanying *supra* notes 268-273.

[278] I.R.C. § 704(b).

[279] Fleischer, *supra* note 276.

[280] Rev. Proc. 93-27, 1993-2 C.B. 343 (treating the receipt of a profits interest for services as non-taxable when received, unless certain exceptions rendering valuation simple and straightforward apply).

[281] 943 F.2d 815 (8th Cir., 1991) (holding that the profits interest in a partnership the taxpayer received for services is not taxable because it has no ascertainable value).

[282] *Id.*

[283] I.R.C. § 83 (governing taxability of property, including a partnership interest, that a taxpayer receives for services and fixing a single point in time for valuation and inclusion of the property in income).

The concession in the revenue procedure[284] produced a tax rule that was administrable but theoretically unsound.[285] Rather than investing in a partnership with assets or money that had been taxed before the partner used that capital to invest in the partnership, as other partners do, partners who received only profits interests for services invest with untaxed service income.[286] A change in the rule makes sense. Any new rule may be inconsistent with the general operation of partnership taxation. If a new rule is consistent with other partnership tax rules, on the other hand, it will prove more complex in practice than the current discussion anticipates. Receipt of the interest will attract a tax on the ordinary income from services equal to the value of the interest received. Later, unless the new rule also restructures the partnership's allocations, the manager also will be taxed on the manager's share of the underlying partnership income as the partnership realizes it – effectively taxing the income from the same partnership source twice.[287] Given Congress' unwillingness to enact legislation that diminishes benefits for hedge and private equity funds and their managers,[288] the change in the tax rules may not find its way to the top of the congressional agenda.

C. *Tax Exempt Investors, Unrelated Business Taxable Income, and Foreign Investors*

Among hedge fund investors are many U.S. tax–exempt organizations for which hedge fund partnerships do not work quite right. Tax exempt organizations, whether of the charitable varieties[289] or retirement plans,[290] are generally free from federal income taxation on their investment income. However, exempt organizations are taxable on any unrelated business income

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[284] Rev. Proc. 93-27, *supra* note 280.
[285] Henry Ordower, Taxing Service Partners to Achieve Horizontal Equity, 46 TAX LAW. 19, 34-38 (1992) (arguing that if valuation is impractical upon receipt of the interest, the transaction should remain open for tax purposes and taxed as valuation becomes practical or as the partner receives payments). And Fleischer, *supra* note 276, reviews much of the extensive literature on the issue.
[286] Ordower, *supra*, note 285.
[287] *Id.* at 38. The second tax as the general partner receives a distributive share under I.R.C. § 702 will increase the general partner's adjusted basis in the partnership interest (I.R.C. § 705) that will compensate for the second level of tax through a smaller taxable gain or a taxable loss on disposition of the partnership interest.
[288] *See supra* text following note 17.
[289] I.R.C. § 501(c)(3) (relating to charitable, educational, religious, etc. organizations that are generally exempt from federal income taxation).
[290] Pension and profit sharing plans under I.R.C. § 401, educational and charitable organization employee plans under I.R.C. § 457, and non-Roth individual retirement accounts under I.R.C. § 409 are generally exempt from federal income taxation under I.R.C. § 501(a). Hedge funds generally monitor retirement plan investment in order to remain under the 25% plan asset limit, lest the fund manager become a fiduciary under ERISA. Department of Labor Regulation, 29 C.F.R. § 2510.3-101. *See* Shartsis Friese, U.S. Regulation of Hedge Funds, *supra* note 38, at 249-265.

they may have.[291] Debt–financed income is unrelated business income.[292] Income from hedge fund partnerships that borrow in order to leverage their investment capital[293] is debt–financed income to the extent of the borrowing. As with all partnerships, the partnership's income retains its character in the hands of its partners.[294] Accordingly, debt–financed income to the partnership retains that character as the partnership allocates it to the exempt organization. If it invests in the partnership, a tax exempt organization's share of the partnership's debt financed income would be subject to the unrelated business income tax.

Hence from the tax exempt investor's perspective a corporate investment vehicle that is not transparent for federal income tax purposes is preferable to a partnership. Neither dividends that the exempt organization receives from the corporate fund nor gain on the redemption or sale of the corporate fund's shares is unrelated business income to the exempt organization investor. The income and gain to the exempt organization is tax exempt, even if the corporate fund incurs substantial amounts of debt in the course of investing.

A U.S. corporation is not the best choice for the hedge fund because the corporation itself will attract a federal income tax on its profit from its investing and trading activities and thereby lose part of its investment return to the income tax. So long as state law or the exempt organization's own governing documents do not prohibit offshore investments, exempt organizations capture their most favorable tax position by investing in offshore hedge funds. Even if the offshore fund is a feeder fund that invests its capital into the U.S. master fund, the offshore fund is still the better choice for exempt organization investors. This is so as long as the offshore fund, if an eligible entity, does not elect U.S. partnership status for tax purposes.[295]

An offshore hedge fund is not a U.S. person for federal income tax purposes, since it is a company formed in and governed by the laws of a foreign jurisdiction.[296] Under U.S. tax law, offshore corporations need not file federal income tax returns,[297] unless they engage in a trade or business in the United States and derive income that is effectively connected with that U.S. trade or business.[298] Even if the foreign corporation maintains an office in the United States that is the source of its trading activity, trading securities or

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[291] I.R.C. §§ 511(a) (imposing a tax on unrelated business income), 512(a)(1) (defining unrelated business taxable income).

[292] I.R.C. § 514 (including that percentage of income from property in unrelated business taxable income as equals percentage of debt financing of property).

[293] *See infra* Part 5, however, for use of derivative products for leverage that may not constitute borrowing.

[294] I.R.C. § 702(b) (2003).

[295] Treas. Reg. § 301.7701-3(b) (2006).

[296] I.R.C. § 7701(a)(30) (2006).

[297] I.R.C. § 6012(a), flush language and Treas. Reg. § 1.6012-2(g)(2) (2006).

[298] I.R.C. § 882 and Treas. Reg. § 1.6012-2(g)(1).

commodities for its own account does not constitute a U.S. trade or business.[299]

Most income of a foreign corporation that is not effectively connected with a U.S. trade or business of that corporation remains free from U.S. income tax. Non–effectively connected gain that a non–U.S. person realizes from the sale or exchange of securities or commodities, even if sold on a U.S. exchange and even if stock in a U.S. corporation, is foreign source income to a non–resident and not subject to U.S. tax.[300] The United States collects a withholding tax at the payment source for many periodic payments from United States sources to a foreign entity. Source withholding applies to interest, dividends, and royalties that non–U.S. persons receive from U.S. sources.[301] It also applies to gain from the sale of intellectual property where payments are a function of the property's productivity,[302] and to the proceeds from the sale of U.S. real property interests.[303] Exceptions for interest from bank deposits[304] and portfolio interest[305] leave little interest income subject to the withholding tax. Since capital gain from securities and commodities trading and portfolio interest constitute the bulk of the offshore hedge fund's income, the fund would pay little or no U.S. income tax.

If the offshore fund is a feeder to the U.S. master partnership, partnership tax rules preserve the character of the partnership's income in the hands of the offshore partner.[306] Preserving character complicates the offshore corporation's tax status, since the partnership claims to be in the

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[299] I.R.C. § 864(b)(2)(A)(ii), (B)(ii) (excluding trading securities and commodities respectively for one's own account from the U.S. trade or business definition). Like the introduction of section 3(c)(7) funds, supra part 2, in 1997, Congress liberalized this trade or business exception to accommodate the hedge fund industry. Before amendment by section 1162(a) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, a securities trading corporation with its principal office in the United States was engaged in a trade or business in the U.S. Treas. Reg. § 1.864-2(c)(iii) sets forth ten criteria (that participants in the hedge fund industry referred to as the "Ten Commandments") to determine whether or not the corporation had its principal office outside the United States. This rule led U.S. hedge fund managers to establish their bases of operation offshore – with a commensurate loss of revenue to states, like New York and Connecticut, where they have had their offices since the 1997 change.

[300] I.R.C. § 865(a)(2).

[301] *Id.* § 871(a)(1) (30% withholding for individual recipients); *Id.* § 881(a)(1) (30% withholding for corporate recipients). Tax treaties with most industrialized countries reduce the withholding tax on dividends and many royalty payments to 10% or less, but the treaty reductions rarely apply to the low-tax jurisdictions in which hedge funds have their residence. *See id.* §§ 1441, 1442 for the withholding obligation imposed on the payer.

[302] *Id.* § 871(a)(4) (30% withholding tax on the gain).

[303] *Id.* § 1445 (10% withholding tax at the source on the proceeds from the sale of U.S. real property interests, as defined in I.R.C. § 897(c)). Foreign corporations may elect to treat income from U.S. real property interests as a trade or business under I.R.C. § 882(d), so that it may file a return and claim deductions for the expenses, including depreciation.

[304] *Id.* §§ 871(i)(1), 881(d).

[305] *Id.* §§ 871(h), 881(c).

[306] *Id.* § 702(b). *See* discussion *supra* in text accompanying note 294.

trade or business of trading securities or commodities in order to position its U.S. individual partners to deduct their shares of expenses free from the 2% floor on miscellaneous itemized deductions.[307] If engaged in a trade or business, the partnership must withhold on any foreign partner's share of partnership income,[308] and not just on periodic income subject to withholding at the source.[309] While not free from doubt, the specific income sourcing rules should override the partnership's general trade or business characterization.[310] With respect to the offshore corporation, as long as the partnership is a trader, as opposed to a dealer, in securities or commodities, the corporation through the partnership is not engaged in a U.S. trade or business. Accordingly, income from the partnership is not effectively connected with a U.S. trade or business. Income from the partnership is subject to withholding at the source only to the extent of the periodic payments withholding rules discussed above[311] and not the more far reaching partnership income withholding.[312] Gain from trading in securities and commodities is not taxable to the offshore fund. Neither the fund, nor its non–U.S. person and exempt organization investors are taxable on the offshore fund's share of the master partnership's income from trading securities or commodities.

D. *Manager's Compensation Deferral Offshore*

Operation of offshore hedge funds with only tax exempt and foreign investors offered U.S. based hedge fund managers the opportunity to defer significant amounts of their compensation without cost to the fund.[313] The manager was not currently taxable when the hedge funds, rather than paying the fees to the manager, contributed all or part of the manager's fees to a trust for the manager's benefit. Deferral of compensation was possible because the trust's assets remained subject to the claims of the fund's creditors.[314] Commonly referred to as a "rabbi trust," the manager did not have to include the trust's assets in income until the trust released them to the manager or, if earlier, the fund's creditors no longer had a claim to them. U.S. corporations

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[307] *Id.* § 67. *See* discussion *supra* in text accompanying note 255.

[308] *Id.* § 1446 (requiring payment by a partnership of a withholding tax on a foreign partner's share of the partnership's effectively connected income).

[309] *Id.* § 881.

[310] *Id.* § 864(b)(2), *supra* note 299 and accompanying text.

[311] *Id.* §§ 871, 881, *supra* note 301 and accompanying text.

[312] *Id.* § 1446, *supra* note 308 and accompanying text.

[313] *See* Henry Ordower, *A Theorem for Compensation Deferral: Doubling Your Blessings By Taking Your Rabbi Abroad*, 47 THE TAX LAWYER 301, at Part III.E. (1994) (discussing offshore application of rabbi trusts).

[314] The Internal Revenue Service has ruled that, as long as the service recipient's creditors may reach the funds, no transfer has occurred for purposes of I.R.C. § 83 (governing the timing and amount of inclusion in income and deduction on transfers to a person other than the payer for the benefit of a service provider). Accordingly, the service provider has no compensation income because a transfer is necessary to the inclusion.

commonly use rabbi trusts to defer compensation for top corporate managers, but the cost to the corporation of providing the benefit is deferral of its compensation deduction until the managers include the rabbi trust assets in their income.[315] Unlike taxable U.S. corporations, however, offshore hedge funds were ideal candidates for the use of rabbi trusts because they were indifferent to the compensation deduction – not being subject to U.S. income tax in any event. Recent changes in deferred compensation rules severely restricted use of offshore rabbi trusts,[316] and imposed strict guidelines on domestic use of such deferral arrangements.[317]

E. *Passive Foreign Investment Companies*

Offshore corporations that serve as acceptable investment pools for tax exempt investors are passive foreign investment companies ("PFIC") for U.S. tax purposes.[318] Before the Department of the Treasury introduced elective tax classification of entities in 1997,[319] taxable U.S. investors did invest in offshore hedge funds even though they were PFICs. While PFIC status has no impact on tax exempt U.S. investors,[320] it affects taxable U.S. investors adversely by classifying some gain the U.S. shareholders might receive from the investment as ordinary income rather than long term capital gain. It also imposes an interest charge on certain distributions from the funds and gains recognized from the sale of interests in those funds.[321] The interest charge is designed to offset the deferral benefit the taxpayer otherwise would capture because the corporation's income is not subject to U.S. taxation and the shareholder not taxable until receiving a distribution on or selling the shares.
U.S. investors may avoid both the interest charge and the ordinary income treatment by electing a current inclusion in income of their shares of the PFIC's income each year.[322] This qualified electing fund election[323] causes the U.S. shareholder to include a proportional share of the fund's income each year. Imputation of the fund's income to the shareholder separates the PFIC's net capital gain from its other income,[324] preserving net capital gain as long term capital gain to the shareholder in much the same manner as a RIC

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[315] I.R.C. § 83(h) (2006).
[316] *Id.* § 409A(b) (added by section 885(a) of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (Oct. 22, 2004)).
[317] I.R.C. § 409A(a).
[318] I.R.C. § 1291-98.
[319] Treas. Reg. § 301.7701-3.
[320] *See* discussion *supra* commencing with the text accompanying note 289.
[321] I.R.C. §1291(a) (imposing ordinary income tax and an interest charge on distributions from a PFIC and gain from the sale of PFIC shares).
[322] Philip S. Gross, *Tax Planning for Offshore Hedge Funds – the Potential Benefits of Investing in a PFIC*, J. OF TAX'N OF INVESTMENTS 187 (2004).
[323] I.R.C. § 1295 (requiring the U.S. taxpayer to elect and the PFIC to agree to provide information necessary to the electing taxpayer's reporting).
[324] I.R.C. § 1293(a)(1).

does.[325] Unlike a RIC, no actual distribution is necessary to carry the income to the shareholder and the shareholder's adjusted basis in the RIC increases by the amount of the inclusion. The PFIC may distribute amounts to the shareholders without further tax equal to the income on which the shareholders paid tax under the imputation. Since the imputed inclusion in the shareholders' income is a function of the PFIC's net income,[326] offshore hedge funds with taxable U.S. investors are not suitable for deferral of the manager's compensation through a rabbi trust. Current deduction for compensation is valuable to the U.S. shareholders because the deduction diminishes taxable income to the shareholders.

V. INVESTMENT POLICIES AND LEVERAGE

Hedge funds tend to emphasize specific investment strategies in which their managers have or claim expertise. A reporter for the hedge fund industry[327] identifies seven main categories of hedge funds: (1) event driven, (2) global, (3) global/macro, (4) market neutral, (5) sectors, (6) short sellers, and (7) long only.[328] Briefly, event driven strategies follow specific types of events, corporate takeovers, for example, and invest either to capture an arbitrage profit in anticipation of the event or in the debt or equity securities emerging from those events. Global funds emphasize investment in securities of non–U.S. issuers and may feature specific world regions, emerging markets, or specific countries. Sectors funds focus on specific business sectors, biotechnology, for example. Long funds invest for appreciation in value, as do equity mutual funds generally. In the retail markets, registered investment companies, including both mutual funds and registered qualified client funds,[329] specialize as well in each of those investment strategies: event driven, global, sectors, and long only funds. In addition, hedge funds may invest in a portfolio of section 3c1 and 3c7 hedge funds. Subject to diversification requirements for registered funds, registered investment companies also might invest in section 3c1 and 3c7 funds.[330]

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[325] *See* RIC discussion *supra* at note 224 and accompanying text.

[326] I.R.C. § 1293(a), (e) bases the imputed income on the company's current earnings and profits, computed under I.R.C. §312. Because of the tie to earnings and profits, the PFIC's ordinary earnings include any tax exempt income that the PFIC may have converts into taxable income in the shareholders' hands.

[327] Managed Account Reports LLC publishes MAR/Hedge, available at http://www.marhedge.com/, (a report on hedge fund activities, and identifies seven basic hedge fund categories).

[328] *See* William Fund and David A. Hsieh, A primer on hedge funds, supra note 38, at 319, for explanation of the various strategies. Similarly, Bankim Chadha & Anne Jansen, *supra* note 17, at 27, 29.

[329] *See* discussion *supra* in text accompanying and following note 199.

[330] Investment Company Act 15 U.S.C. §§ 80a-12(c), (d) (2006). *See* discussion at note 5 and The France Growth Fund, Inc., 2003 SEC No-Action Letter. LEXIS 624, *supra* note 115.

Global/macro funds, on the other hand, emphasize specific risk factors, such as stock indices, currencies, and commodities. They may take large, directional positions where managers conclude that governmental intervention in a country or region is inconsistent with macroeconomic conditions so that a shift is likely to occur. For example, a country may peg its currency unrealistically to a specific exchange rate with the dollar, allowing macro funds to anticipate an exchange rate adjustment when the markets will not sustain the governmental decision. Market neutral funds use long–short and arbitrage strategies. Short–sellers trade on predictions of loss in the value of securities. These last three categories of investment strategy involve investment activities that necessarily include short selling and, therefore, generally are unavailable to the registered investment company industry because short selling involves exposure to debt that investment company regulation limits.[331]

Among other characteristics, leverage from borrowing distinguishes section 3c1 and 3c7 hedge funds from registered investment companies. As registered investment companies, mutual funds and qualified client funds may not incur debt unless the fund has net assets with value at least three times the amount of the debt.[332] Although the SEC has not promulgated regulations implementing the specific prohibitions of margin purchase of securities and short selling,[333] the SEC views both margining and short selling as limited by the general net asset coverage requirement.[334] If they properly disclose their investment policies and risks, mutual funds may employ leverage freely as long as they capture leverage without incurring debt. The SEC has expressed concern about the fund volatility that emanates from the extensive use of various derivative products that create no debt–like obligation but magnify gains and losses.[335]

Leverage magnifies gains and losses thereby rendering the investment more volatile than an investment without leverage. Both borrowing[336] and

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[331] 15 U.S.C. § 80a-18. *See* note 334 *infra*.
[332] *Id.* § 80a-18(a) (applicable to closed-end funds); *Id.* § 80a-18(f) (applicable to open-end funds).
[333] *Id.* § 80a-12(a).
[334] Guidelines for the Preparation of Form N-8B-1, 37 Fed. Reg. 12,790 (1972) (treating short sales and margin purchases as forms of indebtedness or senior securities subject to Investment Company Act § 18).
[335] Mutual Fund Use of Derivatives, *supra* note 68.
[336] For a simple illustration of the leverage through borrowing concept, consider the following examples. If one borrows $100 for one year and must repay $105 (5% interest) at the end of the year but can invest the $100 so that the borrower receives 6% return on invested funds, $106 at the end of the year on the $100 investment, after repaying the debt, the borrower has a net gain of $1 on a zero investment. On the other hand, if the investment yields only $104 at the end of the year, the borrower must provide $1 from her own funds in order to repay the lender – a loss of $1 on a zero investment. If the borrower borrows the $100 and invests her own $100 as well, borrowing has increased a 6% return to a 7% return. That is, the investment yields a 6% return on $200 -- $12 plus return of the original invested funds. After

positions in derivative products[337] create leverage and fund volatility. On a large scale, positive leverage can enhance the return from a successful investment radically, but negative leverage from the unsuccessful, leveraged investment rapidly diminishes investors' capital. The volatility that large amounts of leverage cause increases the risk profile of an investment. Investors in hedge funds (and mutual funds) rarely are willing to assume personal liability for losses in excess of their invested capital, yet, both debt or investment leverage can cause unanticipated and sometimes immediate loss of the invested capital.

The SEC applies the general investment company limitations on debt[338] to derivative products that create financial obligations, including futures contracts, forward contracts, and the writing, as opposed to the purchase,[339] of an option.[340] Those guidelines permit registered investment companies to invest in positions that impose a possible future payment obligation on the investment company, as long as the investment company segregates enough of its assets to cover the obligation. Like a short sale against the box,[341] the segregated account sets aside funds as necessary for the

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repaying $105 to the lender, the borrower has $107 left. On the other hand, in the 4% return example, the borrower has decreased a 4% return to a 3% return ($208 less $105 repayment leaves $103). A larger borrowing, i.e. greater leverage, say $900 at 5% plus the out of pocket $100, a 6% return on the $1000 investment yields $1060 at the end of the year, leaving the investor with $115 after repaying $945 for a return leveraged from 6% to 15%, but a 4% return yields $1040 leaving the investor with only $95 after repaying the $945 for a negatively leveraged return of -5%, a loss of $5 out of pocket.

[337] Derivative products are positions that are not ownership of an underlying tangible or intangible property but that change in value relative to the change in value of the underlying property. For example, equity options are derivatives and provide an easily understood form of leverage. Assume an investor with $100 who may purchase for the $100 either (i) 1 share of XXX Corporation stock or (ii) an option to purchase 200 shares of XXX Corporation stock at the current market price of $100 per share. In the case of the option, the original $100 is the option premium paid to the option writer for selling the option to purchase referred to as a call option. If the stock price advances $10, a purchase of 1 share produces a 10% return. If the investor purchased the option, however, the investor will be able to buy 200 shares for $100 per share and sell them immediately for $110 each, netting $2000 less the option premium $100 for a return of $1900 or 1900%, quite a difference achieved through leveraging. On the other hand, if the XXX Corporation shares remain at $100 per share, the share purchaser loses nothing, but the option purchaser loses 100% of her investment – she will not exercise the option and loses the option premium.

[338] 15 U.S.C. § 80a-18 (2006).

[339] The option writer has an obligation to deliver the subject of the option in kind or settle in cash with the purchaser of an option, while the purchaser's obligation ends with payment of the option premium. The purchaser of an option has no obligation to exercise the option.

[340] Securities Trading Practices of Registered Investment Companies, Release No. 10666, 1979 SEC LEXIS 1744 (SEC 1979).

[341] Short sale against the box refers to a short sale when the short seller holds the same securities in its portfolio and could use the portfolio securities to return the borrowed securities if necessary. A short sale is the sale of borrowed securities in the expectation that the securities will have declined in value when it comes time to return the borrowed

cover. The investment company must fund the segregated account with high grade liquid securities, such as government bonds, and cash. It also must mark the risk position to market daily, so that the investment company may adjust the amount in the segregated account to cover any decline in the value of the position.[342] Segregation limits the amount of debt–type leverage the investment company may employ by making the segregated funds unavailable for any other purpose.

No similar limit applies to leverage that involves no future obligation, like a purchased option, for example. However, disclosure of the investment policy and risk may be necessary in the fund's prospectus and other public documents.[343] Further, derivatives that do not trade on an established market may involve significant counterparty risk.[344] Where an established trading market exists, the Chicago Board Options Exchange, for example, the market operates as a hedged intermediary that standardizes the contractual terms and serves as the counterparty on all market traded contracts.[345] In the case of over the counter contracts, there may be no hedged intermediary as the contract counterparty or the hedged intermediary that is the counterparty may become unable to collect on cash settlements owed to it. In either instance, and despite requirements for collateralization from its counterparties, the counterparty may not meet its obligations under the contract, especially following sudden market movements adverse to the counterparty's investment strategy. Most often, however, the counterparty will be an established and reliable financial institution that remains perfectly or nearly perfectly hedged

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securities. The short seller then may purchase replacement securities on the market for a lower price than that for which the short seller sold the borrowed securities. That differential between the short sale price and the cover purchase price is profit to the short seller. If, however, the underlying security increases in value, rather than decreasing as the short sale anticipates, the short seller has to buy the cover at a price higher than the short sale price, and that purchase will cause an overall loss. If the seller has portfolio securities for cover, the seller is protected from having to buy the securities at the higher price on the market. Generally, tax rather than economic strategies precipitate a short sale against the box since economically, if one anticipates decline in value, one may lock the current value by selling the portfolio securities.

[342] Securities Trading Practices, supra note 340, in section SEGREGATED ACCOUNT, note 15 and text.

[343] *Id* at note 18 referring to the registration statement under section 80a-8(b) of the Investment Company Act, reports to shareholders under section 30, sales literature under section 24(b), and proxy statements under section 20.

[344] Counterparty refers to the other party to a two party derivative contract.

[345] Exchanges issue offsetting positions, so that when one position retreats in value, the offsetting position advances in value in an equal amount leaving the issuer protected (hedged) against loss. Commodities futures exchanges require purchases of position to post margin and to increase their margin deposits whenever their positions decline in value. Margin is amount slightly greater than the excess of the obligation of the investor over the current value of the position, that is, margin exceeds the amount the investor would have to pay if the investor closed out the position by purchasing an offsetting position currently. Margin protects the exchange from the financial failure of the investor.

on its derivative positions. It functions much like a commodities futures exchange as a facilitator and receives a fee, rather than an investment return, for serving as a derivative contract intermediary. It establishes procedures to monitor the values of its positions and the collateral that counterparties have posted with it. Nevertheless, its financial stability is never quite so firm as most of the established options and futures exchanges.

No similar constraints on leverage apply to section 3c1 and 3c7 funds. They may borrow directly, subject to any limitations that other regulatory agencies may impose on lenders or derivative counter parties. In the United States, the Federal Reserve Bank, the Comptroller of the Currency, or state regulators may impose lending limits on regulated financial institutions' lending practices. However, those regulations only indirectly operate on the hedge funds. Indeed the hedge funds may be able to establish different types of credit arrangements with a variety of lenders, thereby maximizing the hedge funds' access to credit. Likewise, those hedge funds may take derivative positions without regard to whether the positions impose a future obligation on the fund. The only controls on hedge funds' derivative exposure are (i) internal, voluntary controls, if any, designed to prevent the fund from taking excessive risk and failing and (ii) the willingness of derivative counter–parties to enter into contracts with the hedge fund. Hedge fund managers who have strong reputations, like Long Term Capital Management had in 1998,[346] have the ability to take investment positions through derivatives and direct borrowing that have exposure many times the amount of their invested capital.

Part 6. Conclusion – Additional Regulation Needed?

As part 2 of this article demonstrated, the fundamental structure of the Investment Company Act, the Securities Act, and the registration requirements of the Securities Exchange Act enable hedge funds to avoid the regulatory framework of those laws. The statutory design of those Acts and the regulations that the SEC has promulgated interpreting those statutes reflect Congress's and the SEC's conclusion that certain investors need neither the protection that registration offers nor the more parental limitations on investment activity and advisory fees that the Investment Company Act and the Advisers Act offer to the public. Congress confirmed and expanded the exemptions from registration when it introduced section 3c7 funds for qualified purchasers in 1997[347] and exempted their advisors from advisory fee limits.[348] The SEC further facilitated creation of a type of registered fund for moderately wealthy investor that could operate free from advisory fee restrictions. Antifraud rules suffice to protect the wealthy investing public that forms the market for hedge funds. As they do with all other transactions in securities, whether or not exempt from registration, antifraud rules outlaw

[346] *See* discussion of Long Term Capital Management, *supra* note 7.
[347] 15 U.S.C. § 80a-3(c)(7) (2006).
[348] 15 U.S.C. § 80b-205(a)(4) (2006).

market manipulation and require disclosure of material information even when the security in question is an interest in a hedge fund.[349] Little if any evidence suggests that registration should be expanded to protect sophisticated and wealthy investors.[350] On the contrary, registration impedes the flexibility that such investors may wish to have in their selection of investment structures suitable to the investors' own risk tolerances. And both Congress and the Internal Revenue Service have accommodated tax laws and their interpretation to the needs of the private investment company community. The SEC's recently proposed regulation that would impose stringent disclosure standards on advisers to hedge may serve to enhance investor protection in this area.[351]

Similarly, increased regulation of hedge funds does not seem the correct course for control of leverage risk. If necessary, increased regulation of investors in and lenders to hedge funds would address that concern more directly. If lenders are at risk because they extend too much credit to hedge funds, lending limits and similar regulatory controls — some possibly already in place but suffering from lax internal and external enforcement[352] — targeted to the lenders seem more appropriate. If some municipal governments, public corporations, or pension plans should not invest in hedge funds, for others hedge funds might be a perfectly acceptable and appropriately controlled portion of their portfolios. Beyond inquiring whether or not investors meet basic qualified purchaser requirements,[353] the government agency regulating the investor's primary industry sector, the investing corporation's board of directors, or the investing pension fund's managers would be the most suitable targets for regulation because they know the investor that is at risk far more intimately than a hedge fund manager can. Requiring hedge funds to monitor the solvency and investment mix of their investors is impractical. The funds do not have and cannot at reasonable expense obtain and analyze their investors' portfolios.

Perhaps the existing statutory framework to prevent and sanction market manipulation inadequately controls the activities of hedge funds. Increased transparency that would have accompanied registration of investment advisers[354] and, in the future, possibly hedge funds themselves under a separate registration regime, unaccompanied by parental limitations on investment activities or fees, may have helped to prevent market

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[349] 15 U.S.C. § 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2006).

[350] *Accord* Sharma, Sunil (1998). "Regulation of Hedge Funds," in *Hedge Funds and Financial*
Market Dynamics. Occasional Paper Series 166. B. Eichengreen, D. Mathieson
(Hrsg.). Washington DC.: International Monetary Fund, S. 62; *see* Dissent of Commissioners Glassman & Atkins, *supra* note 18.

[351] Proposed regulation § 206(4)-8, 17 C.F.F. § 206(4)-8 (2007 proposed), *supra* note 21.

[352] *Compare* Sunil Sharma, supra note 350, at 67-8.

[353] 15 U.S.C. § 80a-2(a)(51) (2006).

[354] 17 C.F.R. § 275.203(b)(3)-2 (2006), held invalid in Goldstein v. SEC, *supra* note 19.

manipulation by hedge funds. Hedge funds may have significant market power because of their ability to raise both equity and debt capital. If hedge funds have sufficient market power to generate significant market movements, integrity and stability of the markets may depend in part on access to information concerning the positions hedge funds hold and trade. Hedge fund managers are understandably opposed to and suspicious of governmental intervention into their activities that have remained free from regulation for many years. Regulation certainly would have increased the costs of operating hedge funds, but the SEC concluded that the compliance cost that it recently sought to impose upon hedge fund advisers was not great relative to the amount of funds under management.[355] Managers differed the SEC with respect to cost assessment and prevailed in the courts.[356]

A greater concern for managers may have been that information reporting would provide access to the managers' investment strategies and portfolio management techniques that the managers consider to be proprietary information. Compromise of their trade secrets might cost some managers their ability to remain as successful as they are. That concern seems legitimate although it may be only a smokescreen. Perhaps managers feared that investors with greater access to information would learn that many hedge fund managers have no great talent for investment management. In order to raise capital, some managers may have relied upon the hedge fund mystique that secrecy created. Once the mystery would disappear, their ability to corral investors may have disappeared as well.

[355] Registration Under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 18, at 72,080-1 (estimating compliance costs at approximately $50,000). *But see* Dissent of Commissioners Glassman & Atkins, *supra* note 72, at 72,095, for a much higher estimate of compliance costs.

[356] Goldstein v. SEC, *supra* note 19 (holding the regulation counting clients and requiring registration of many hedge fund advisers invalid).