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The Intersection Between Finance and Intellectual Property: Trade Secrets, Hedge Funds, and Section 13(f) of the Exchange Act

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I. INTRODUCTION

On June 23, 2006, the U.S. Court of Appeals for the District of Columbia decided what is now the seminal case of *Goldstein v. SEC*.[1] In *Goldstein*, Philip Goldstein, a prominent hedge fund manager, challenged the validity of the "Hedge Fund Rule," promulgated by the Securities and Exchange Commission ("SEC" or the "Commission").[2] The basic premise of the rule was that although many hedge funds were exempt from registration with the SEC under certain provisions in the federal securities laws,[3] the rule redefined "client" under the Investment Advisers Act of 1940[4] ("Advisers Act") to include individual shareholders, partners, or beneficial owners.[5] Prior to the Hedge Fund Rule, hedge funds were able to circumvent registration under the Advisers Act because the hedge fund manager could count the fund itself as a client, rather than the individual investors of the fund, and therefore, meet the exemption requirement of having fewer than fifteen clients.[6] Under the Hedge Fund Rule's redefinition of client, however, many hedge funds that had been exempt would have had to register and comply with SEC regulations by February 1, 2006.[7]

In *Goldstein*, the Court of Appeals struck down the Hedge Fund Rule as being "completely arbitrary."[8] Even though the SEC announced shortly thereafter that it would not seek an appeal,[9] the SEC was not finished attempting to regulate hedge

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1. 451 F.3d 873 (D.C. Cir. 2006).
2. *Id.* at 874.
3. For an overview of the registration exemptions available to hedge funds under the federal securities laws, see Sargon Daniel, Note, *Hedge Fund Registration: Yesterday's Regulatory Schemes for Today's Investment Vehicles*, 2007 Colum. Bus. L. Rev. 247, 257–67.
4. Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2006).
5. *Id.* § 80b-3(b)(3); *see also* Sue Ann Mota, *Hedge Funds: Their Advisers Do Not Have to Register with the SEC, but More Information and Other Alternatives Are Recommended*, 67 La. L. Rev. 55, 64 (2006).
6. *See* Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. Davis Bus. L. J. 323, 326 (2007) ("The revised regulations [the Hedge Fund Rule] 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.").
7. *See Goldstein*, 451 F.3d at 877.
8. *Id.* at 883.
9. *Hedge Fund Manager May Challenge SEC*, L.A. Times, Sept. 13, 2006, at C4.

funds,[10] and hedge fund managers, like Philip Goldstein, were certainly not done attacking other SEC regulations that affect hedge funds.[11]

Despite the Court of Appeals's rejection of the Hedge Fund Rule, hedge funds that are not required to register with the SEC may still be subject to certain disclosure requirements. One such disclosure requirement is section 13(f) of the Securities Exchange Act of 1934 ("Exchange Act"), which requires institutional investment managers,[12] whether registered with the SEC or not, who hold securities with a

10. *See* Keith W. Miller & Jean M. Vrola, *The SEC Continues to Scrutinize Hedge Funds and File Enforcement Actions*, 236 N.Y. L.J. 9 (2006); Nicolas Morgan, Perrie M. Weiner & Edward Totino, *SEC Rings in 2007 with Three-Pronged Assault on Hedge Funds and PIPEs*, 12 No. 21 Andrews Sec. Litig. & Reg. Rep. 2 (2007); Ordower, *supra* note 6, at 326–27; *see also*, *e.g.*, *How Rich Is Rich Enough to Invest in a Hedge Fund?*, The Kiplinger Letter, May 18, 2007, *available at* 2007 WLNR 9473733 ("The SEC will raise the bar this year, requiring that investors in the roughly 9000 lightly regulated investment pools [i.e., hedge funds] worldwide have at least $2.5 million in investable assets before taking the plunge. The amount must exclude equity in a home or business. The new threshold is quite a jump from the current criteria: $1 million in net worth and $200,000 in annual income for individuals or $300,000 for couples.").

11. In the fall of 2006, Phillip Goldstein announced that he would next attack the SEC regarding section 13(f)'s disclosure requirements. *See Do Hedge Funds Hold 'Trade Secrets'?*, Bus. Wk. Online, Sept. 13, 2006, http://www.businessweek.com/investor/content/sep2006/pi20060913_356291.htm; Riva Froymovich, *Hedge Fund Manager May Challenge SEC—Again*, Investment News, Sept. 18, 2006, at 6; Lori Pizzani, *Hedge Fund to Challenge SEC, Again: Denial of 13f Regulatory Exemption to Prompt New Lawsuit*, Money Mgmt. Executive, Sept. 18, 2006. According to Mr. Goldstein, his "investments . . . are his intellectual property—trade secrets that the SEC shouldn't force him to reveal any more than it would ask Yum Brands to put the recipe for KFC chicken into its annual report." Michael Maiello, *Hands Off My Stocks*, Forbes, Dec. 11, 2006, at 58. By likening his investments to trade secrets, Mr. Goldstein has claimed that mandatory disclosure of those investments to the SEC constitutes a government taking of property without just compensation in violation of the Fifth Amendment. *Id*. To view Mr. Goldstein's application for exemption from Rule 13f-1, see Full Value Advisors, Application for an Order Pursuant to § 13(f)(2) of the Securities Exchange Act of 1934 ("The 1934 Act") for Exemption from Rule 13f-1 of the 1934 Act (Oct. 24, 2006), *available at* http://www.pomtalk.com/pomtalk/files/request_for_exemption_from_rule_13f1.pdf [hereinafter Goldstein Exemption Application]. For a detailed analysis of Mr. Goldstein's application, see Edward Pekarek, Note, *Hogging the Hedge? "Bulldog's" 13F Theory May Not Be So Lucky*, 12 Fordham J. Corp. & Fin. L. 1079 (2007). In Mr. Pekarek's estimation

> [t]he Goldstein Application is certainly a creative and colorful document filled with the sort of irascible rhetoric that made Philip Goldstein a recognized market maverick in 2006. However, when one delves deeper than what is in some instances little more than baseless bluster, the Application falls short at a number of levels.

Id. at 1180.

12. For the purposes of section 13(f), an institutional investment manager "includes any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person." 15 U.S.C. § 78m(f)(5)(A) (2006). According to the SEC's website about Form 13F, an institutional investment manager is:

> (1) an entity that invests in, or buys and sells, securities for its own account; or (2) a person or an entity that exercises investment discretion over the account of any other person or entity. Institutional investment managers can include investment advisers, banks, insurance companies, broker-dealers, pension funds, and corporations.

SEC, Form 13F—Reports Filed by Institutional Investment Managers, http://www.sec.gov/answers/form13f.htm (last visited Apr. 18, 2008).

combined value of at least $100 million to disclose their holdings on a quarterly basis.[13] That disclosure, known as a Form 13F report, is shortly thereafter made public by the SEC. Many hedge funds' securities holdings—specifically, the way in which those holdings are allocated—represent a core part of their trading strategies and arguably their trade secrets.[14] In a difficult and volatile market, these trading strategies take on even more importance.[15]

The SEC has the discretion to grant confidential treatment to an institutional investment manager's Form 13F report under the Freedom of Information Act ("FOIA").[16] The available FOIA exemption for trade secrets, however, is narrowly defined, and if the SEC refuses to grant confidential treatment to a Form 13F report, the only recourse that a manager has is to bring a court action.[17] In reviewing an agency's "reverse-FOIA"[18] decision, courts apply an "arbitrary and capricious" standard, which gives the court very little discretion to overturn an agency's decision.[19] Therefore, a hedge fund manager seeking confidential treatment of a Form 13F report has a difficult burden to overcome.

Part II of this note explores the history and growth of hedge funds. Part III examines the legislative history of section 13(f) of the Exchange Act, as well as the disclosure requirements and exemptions. Part IV argues that the exemptions available to institutional investment managers who wish to keep their Form 13F reports non-public are extremely narrow and that the standard of review for agency decisions regarding confidential treatment of involuntary information is too strict. This note concludes that the SEC should consider providing an automatic exemption to hedge fund managers who wish to receive confidential treatment for their holdings.

II. THE GROWTH OF HEDGE FUNDS

A. What Is a Hedge Fund?

There is no statutory definition of hedge funds provided by the securities laws;[20] however, a hedge fund is typically thought of as "any pooled investment vehicle that

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13. *See infra* Part III.A and note 59.

14. *See infra* Parts III.C, IV.

15. *See, e.g.*, Duff McDonald, *The Running of the Hedgehogs*, N.Y. Mag., Apr. 9, 2007, *available at* http://nymag.com/news/features/2007/hedgefunds/30341/. According to McDonald, hedge funds remain popular despite their "uneven performance of late" in part because of "how they performed five years ago": from 2000 to 2002, "when the market fell 40 percent following the dot-com collapse, the average hedge fund didn't lose money." *Id.*

16. *See infra* Part III.C.

17. *See infra* Part III.C.

18. *See infra* Part III.C.

19. *See infra* Part III.C.

20. *Goldstein*, 451 F.3d at 874–75; Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 Temp. L. Rev. 681, 683 (2000). History has it that

> [t]he term "hedge fund" was coined in 1949 when it was used to describe a private partnership managed by Alfred Winslow Jones. Fearing poor returns during market

is privately organized, professionally administered, and not widely available to the public."[21] Hedge funds "are different from other investment vehicles, such as mutual funds or other types of asset managed funds, because they tend to employ leverage more aggressively and they engage in highly active and short-term trading strategies."[22] Although hedge funds often engage in long-short strategies to achieve high returns,[23] there are many other strategies that may be employed.[24] For example:

> [H]edge funds don't make returns just by taking short positions . . . against a particular asset class. Instead, the hedges deploy a vast arsenal of approaches: short positions, long positions (bets on a price increase of a particular asset), long-short, neutral, directional, event-driven, multistrategy, equity, bond, global macro, commodity and others.[25]

Moreover, although hedge funds are typically considered "private," Fortress Investment Group LLC, an alternative asset manager that includes a hedge fund, went public in February 2007, thus further complicating the common notion of a hedge fund.[26]

While it is true that there have been significant hedge fund collapses, which have harmed the investors of those funds,[27] hedge funds also provide the financial markets with important benefits. For example, "[h]edge funds invest in new and often undercapitalized markets. This enhances liquidity in less traditional markets. Hedge funds also often purchase derivatives and take short positions, which increases

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> slumps, Jones created a "hedging" strategy that would neutralize the effect of market factors on his portfolio's performance. He invested in both long and short positions in common stocks, while using a modest amount of leverage to hedge his bets, so that changes in equity markets would affect only half of his investment portfolio.

Melissa Antoszewski, *Las Vegas Style Investing: In the Absence of Regulation, Risky Hedge Fund Bets Can Win Big and Lose Even More*, 8 Transactions: Tenn. J. Bus. L. 381, 382 (2007).

21. Mota, *supra* note 5, at 55.

22. Gibson, *supra* note 20, at 683.

23. *See* Alan J. Berkley & Michael J. Savitz, *Recent SEC Proposal on Short Position Disclosure*, *in* Advanced Securities Law Workshop 1991, at 137, 146–47 (PLI Corp. Law and Practice Handbook Series No. B4-6975, 1991), WL 748 PLI/Corp 137. According to the authors:

> A short sale is the sale of a security that the seller does not own or that he owns but does not deliver. In order to deliver the security to the purchaser, the short seller will borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by returning the security to the lender, typically by purchasing equivalent securities on the open market. In general, short selling is utilized to profit from an expected downward price movement, or to hedge the risk of a long position in the same security or in a related security.

Id. Essentially, taking a long position is betting that its value will increase, while taking a short position is betting that its value will decrease.

24. *See* Gibson, *supra* note 20, at 685–86 (discussing various hedge fund trading strategies).

25. Michael Wallace, *Will Hedge Funds Get Squeezed?*, Bus Wk Online, Apr. 4, 2005, http://www.businessweek.com/bwdaily/dnflash/apr2005/nf2005044_1038_db016.htm.

26. Fortress Inv. Group LLC, Prospectus (Form 424B4) (Feb. 8, 2007).

27. *See infra* Part II.C.

reliability to market prices and may limit irrational security appreciation."[28] Furthermore, shortly after the decision in *Goldstein*, members of the Senate Committee on Banking, Housing, and Urban Affairs "uniformly acknowledged the significant and beneficial role that hedge funds play in today's market by contributing to market diversification, efficiency, and liquidity . . . ."[29]

B. The Proliferation of Hedge Funds

In 2003, the SEC published a staff report that examined the effects and implications of hedge fund growth. The report noted that, despite a lack of information about hedge funds, the SEC refocused its attention on hedge funds and their potential regulation because of the "recent growth of the industry and the increase of investments in hedge funds by institutions."[30] The staff report further noted that:

> The Commission's inability to examine hedge fund advisers has the direct effect of putting the Commission in a "wait and see" posture vis-à-vis fraud and other misconduct. . . . We also are concerned that some hedge fund investors may not always receive useful information about the investment adviser and its management of the fund. . . . One of our key concerns relates to the manner by which hedge fund advisers value hedge fund assets . . . . Our concern not only reflects our recognition of the incentives that may cause an adviser to inaccurately value hedge fund assets, but it also reflects our concern that registered funds that invest their assets in hedge funds may lack access to information that enables them to "fair value" their interests in hedge funds and therefore accurately calculate their net asset value.[31]

Although regulators are often focused on the proliferation of hedge funds, the interest in these funds is also based on the fact that hedge fund managers are some of the richest people[32] in America.[33] One journalist, who examined the extreme wealth

28. Carl J. Nelson, Note, *Hedge Fund Regulation: A Proposal to Maintain Hedge Funds' Effectiveness Without SEC Regulation*, 2 Brook. J. Corp. Fin. & Com. L. 221, 234–35 (2007); *see also* Berkeley & Savitz, *supra* note 23, at 147 ("Short selling provides the market with two important benefits: market liquidity and pricing efficiency.").

29. Barry P. Barbash, *Recent Regulatory Developments Affecting Private Funds*, 2006 A.L.I.-A.B.A 119, 124 (2006).

30. SEC, Implications of the Growth of Hedge Funds x (2003) [hereinafter SEC Staff Report], *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

31. *Id.* at x–xi.

32. *See* David Leonhardt, *Worth a Lot, but Are Hedge Funds Worth It?*, N.Y. Times, May 23, 2007, at C1.

33. *See, e.g.*, Jenny Anderson & Julie Creswell, *Make Less Than $240 Million? You're off Top Hedge Fund List*, N.Y. Times, Apr. 24, 2007, at A1 (noting that the earnings of the leading hedge fund managers "dwarf[] that of the top chiefs on Wall Street"); Jenny Anderson, *Managers Use Hedge Funds As Big I.R.A.'s*, N.Y. Times, Apr. 17, 2007, at A1 (attributing this "new class of financial giants," in part, to hedge fund managers' "ability to earn the bulk of their compensation offshore and invest it in their funds, where it grows tax-free"); *The Rankings: The Hedge-Fund Elite*, N.Y. Mag., April 16, 2007, at 46 ("Steven Cohen ($2.5 billion), and Paul Tudor Jones II ($2 billion)"); Thierry Olivier Desmet, *Understanding Hedge Fund Adviser Regulation*, 4 Hastings Bus. L. J. 1, 1 (2008) ("[H]edge funds have reached a near-mythical

of hedge fund managers located in Greenwich, Connecticut, based her definition of hedge funds on their respective fee structures:

> The typical hedge fund charges its investors an annual management fee of 2 percent of assets under management—plus a performance fee equal to 20 percent of that year's return. In other words, just for showing up at work, the manager of a midsize hedge fund with $2 billion in assets is guaranteed to earn $40 million a year in fees alone. That's before his cut of any returns.[34]

Considering that as of early 2008 hedge funds managed approximately $2 trillion,[35] there is certainly a great amount of money to be made by hedge fund managers. This estimate nearly doubles a mid-2006 figure reporting that hedge funds managed roughly $1 trillion.[36] Furthermore, comparing these figures to a 1998 statistic, which reported that hedge funds had approximately $200 to $300 billion in capital,[37] it becomes clearer that there has been an influx of capital into hedge funds, and that is certainly one reason why hedge funds receive such attention.[38]

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status in the securities industry, inspiring feelings of admiration and fascination, but also envy and fear in many people."); Leonhardt, *supra* note 32 (attributing hedge funds' success to their fee structure and that they take a large cut of profits above a predetermined benchmark); Nina Munk, *Greenwich's Outrageous Fortune*, Vanity Fair, July 2006, at 124, 129 ("On the latest Forbes Four Hundred list of the richest Americans you'll find four people who live in Greenwich; three of them manage hedge funds: Edward Lampert (estimated net worth: $3.5 billion)."); *see also* discussion *infra* Part II.C.

34. Munk, *supra* note 33, at 130; *see also* Desmet, *supra* note 33, at 6 ("Hedge fund managers charge hefty fees well in excess of those usually associated with money management. Typically, these fees include a management fee of 1 to 2% of an investor's assets under management in addition to a bonus or incentive fee of 15 to 20% of the fund's profits. In a year with generally good performance from the market averages, the managers of the largest hedge funds can earn several hundred million dollars by substantially outperforming them."). Furthermore, one of the reasons why many hedge funds do not want to register with the SEC is because of the effect such registration would have on their fees. *See Goldstein*, 451 F.3d at 877 n.3 ("[R]egistered advisers must open their records to the Commission upon request and cannot charge their clients a performance fee unless such clients have a net worth of at least $1.5 million or at least $750,000 under management with the adviser." (internal citation omitted)).

35. *See, e.g.*, Jenny Anderson, *Wall Street Winners Hit a New Jackpot: Billion-Dollar Paydays*, N.Y. Times, Apr. 16, 2008, at A1 (reporting that there are an estimated 10,000 hedge funds in existence, with approximately $2 trillion of assets).

36. *Regulating Hedge Funds: The Wilder Side of Finance*, Economist, July 1–7, 2006, at 11.

37. Gibson, *supra* note 20, at 685.

38. According to an article in *New York Magazine*, "there are more than 9,000 hedge funds, 351 of which manage $1 billion or more." McDonald, *supra* note 15; *see also* Stephen Fraidin & Daniel S. Hoverman, *Hedge Fund Activism*, *in* 38th Annual Institute on Securities Regulation 401, 405 (PLI/Corp. Law and Practice Course Handbook Series No. 9151, 2006), *available at* WL 1571 PLI/Corp 401 ("SEC Chairman Christopher Cox testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs on July 25, 2006, that 'the SEC's best estimate is that there are now approximately 8,800 hedge funds, with approximately $1.2 trillion of assets. If this estimate is accurate, it implies a remarkable growth in hedge fund assets of almost 3,000% in the last 16 years.'").

C. Significant Hedge Fund Collapses

Investors, regulators, and lay people became especially cognizant of hedge funds when Long-Term Capital Management ("LTCM") collapsed in 1998, resulting in a "bailout of over $3.5 billion, . . . the largest-ever bailout of a hedge fund by private financial institutions."[39] Due to the large amount of leverage that was provided to LTCM, the fund's creditors would have lost an enormous amount of capital if the bailout did not occur, potentially crippling the financial markets in the process.[40]

Founded in 1993 and located in Greenwich, Connecticut,[41] LTCM was the brainchild of John W. Meriwether, a successful bond arbitrageur.[42] Meriwether was a strong believer in the unfailing accuracy of models to predict dips in the market, which he could exploit to his advantage. He recruited likeminded individuals, particularly academics, to work for LTCM, including two Nobel Prize winners.[43] As is often seen in hedge funds' strategies, Meriwether chose to leverage the fund to increase returns, resulting in "more than $1 trillion worth of exposure" for the large Wall Street banks that provided the fund with leverage.[44] Although LTCM was originally touted as the golden child of hedge funds because of its annual returns, which often exceeded forty percent,[45] its swift and frightening collapse has made it synonymous with the dangers of hedge funds.[46] Partially as a result of LTCM's collapse, the SEC promulgated the now defunct Hedge Fund Rule.[47]

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39. Mota, *supra* note 5, at 62–63. Apparently, the collapse occurred because LTCM "used $30 of leverage for every $1 in capital." Munk, *supra* note 33, at 130.

40. *See* Gibson, *supra* note 20, at 681–82.

41. According to one commentator, "the highest concentration of hedge fund advisers appears to be in Connecticut, where at least 512 hedge funds, managing around $111 billion, existed as of late September 2005." Desmet, *supra* note 33, at 5.

42. *See generally* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000) (chronicling the formation and collapse of LTCM).

43. *Id.* at 116.

44. *Id.* at xix.

45. *Id.*

46. *See, e.g.*, Tobias Adrian, *Measuring Risk in the Hedge Fund Sector*, 13 CURRENT ISSUES IN ECON. & FIN. ¶ 2 (2007) ("[T]he collapse of the hedge fund Long-Term Capital Management (LTCM) in 1998 seemed to confirm fears that heavy losses by hedge funds have the potential to drain significant liquidity from key financial markets."). LTCM's demise was predicated on a number of factors, "[t]he perfect storm of [:] (i) high leverage, (ii) adverse and unanticipated market events, (iii) poor risk management, and (iv) shrinking liquidity in the financial markets." Rhett G. Campbell, *Financial Markets Contracts and BAPCPA*, 79 AM. BANKR. L.J. 697, 699 (2005). For a more detailed analysis of LTCM's collapse, see LOWENSTEIN, *supra* note 42, at 123–85.

47. Recent Cases, *District of Columbia Circuit Vacates Securities and Exchange Commission's "Hedge Fund Rule*," 120 HARV. L. REV. 1394, 1394 (2007) [hereinafter Recent Cases]; *see also* Daniel P. Collins, *Manipulating a Hedge Fund Blow-Up*, FUTURES MAG. GROUP, Sept. 1, 2007, *available at* 2007 WLNR 17122369 (indicating that the implosion of LTCM created calls for regulatory action).

LTCM is not the only hedge fund to collapse or the last to garner the attention of regulators.[48] Although it apparently began as a legitimate hedge fund in the 1990s, Bayou Funds, a Connecticut-based hedge fund, suffered losses, which it concealed from its investors through an elaborate accounting scheme and by proclaiming inaccurate returns.[49] According to an SEC press release, "from 1996 through 2005, investors deposited over $450 million into the Bayou Funds," and the fund's managers "grossly exaggerat[ed] the Funds' performance to make it appear that the Funds were profitable and attractive investments, when in fact, the Funds had *never* posted a year-end profit."[50]

The more recent collapse of another Greenwich-based hedge fund, Amaranth Advisers ("Amaranth"), has also drawn the attention of regulators and investors.[51] In September 2006, Amaranth, which employed a multi-strategy trading tactic,[52] lost approximately $6 billion.[53] The immense loss was essentially based on a single trading strategy: a bet that the future prices of natural gas would rise in certain months in a two-year period.[54] That a hedge fund could collapse because of a single strategy, or even a single trade, is not extraordinary.[55] However, Amaranth's collapse

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48. *See, e.g.*, James Mackintosh, *Resurrection of a Hedge Fund*, FIN. TIMES, Aug. 23, 2007, *available at* http://search.ft.com/ftArticle?queryText=Resurrection+of+a+Hedge+Fund&y=0&aje=true&x=0&id=070823000626&ct=0 (discussing the investigation of the collapse of Amaranth Advisors). The call for regulation of hedge funds is not strictly limited to the United States. Germany's finance minister, Peer Steinbruck, also "has been calling for increased scrutiny of hedge funds." *German Sees Sentiment for Hedge Fund Rules*, INT'L HERALD TRIB., Sept. 5, 2007, at 9, *available at* 2007 WLNR 17307698; *see also* Alistair MacDonald & Deborah Solomon, *Hedge Funds from Europe Take a Crack at Self-Policing*, WALL ST. J., Oct. 11, 2007, at C1 (discussing regulation of hedge funds as a political issue in Europe).

49. *See* Roddy Boyd, *Burning Hedges—One Time Whiz Kid Knew How to Cover Tracks*, N.Y. POST, Dec. 17, 2006, at 31; Roddy Boyd, *Mets Owner Sued in Bayou Collapse*, N.Y. POST, Sept. 13, 2006, at 42; Greg Farrell, *Empty Promises in Hedge Fund Fraud*, USA TODAY, Sept. 30, 2005, at 3B.

50. Press Release, SEC, SEC Charges Samuel Israel III, Daniel E. Marino, Bayou Mgmt, and Bayou Funds for Defrauding Hedge Fund Investors and Misappropriating Investor Assets (Sept. 25, 2005) (emphasis added), *available at* http://www.sec.gov/news/press/2005-139.htm. Both Marino and Israel were sentenced to twenty years in prison and required to make millions of dollars in restitution. Leslie Gervirtz & Martha Graybow, *Bayou Co-Founder Sentenced to 20 Years in Prison*, REUTERS, Apr. 14, 2008, http://www.reuters.com/article/ousiv/idUSN1436726120080415.

51. *See* Mackintosh, *supra* note 48.

52. *See* Gretchen Morgenson & Jenny Anderson, *A Hedge Fund's Loss Rattles Nerves*, N.Y. TIMES, Sept. 19, 2006, at C1 (adding that, in light of Amaranth's "huge losses in a single sector," the term "multistrategy seems to have been a misnomer").

53. *See* Recent Cases, *supra* note 47, at 1394.

54. *See, e.g.*, Morgenson & Anderson, *supra* note 52 ("Amaranth's biggest stake was a combination bet on the spread between natural gas futures prices for March 2007 and those for April 2007. Amaranth had often bet that the spread on that so-called shoulder month—when natural gas inventories stop being drawn down and begin to rise—would increase.").

55. *See, e.g.*, A.V. Rajwade, *The Head and Tail of Hedge Funds*, BUS. STANDARD, Oct. 9, 2006, at 8, *available at* http://www.business-standard.com/india/storypage.php?autono=261024 (noting that "the mortality rate in hedge funds is around 7 to 10 per cent per annum of the population with a much higher percentage in the first year"); Gregory Zuckerman, *Veteran Trader Loses Investor, Closes a Fund*, WALL ST. J., Oct.

resulted in an action brought against the fund and its lead trader, Brian Hunter, by the Commodity Futures Trading Commission for price manipulation, as well as a congressional study by the Senate Permanent Subcommittee on Investigations ("PSI"), which found widespread effects, such as increased prices and volatility in the market, due to Amaranth's trades in natural gas.[56] Again, as with LTCM and Bayou Funds, the collapse of Amaranth drew the attention of both investors and regulators to the question of hedge fund regulation.[57]

III. SECTION 13(F) OF THE SECURITIES EXCHANGE ACT OF 1934

A. What Must Non-Regulated Hedge Funds Disclose?

An investment company, fund, or firm that is not registered with the SEC and therefore not generally subject to the various federal securities regulations does not have to disclose much information to the SEC.[58] The accompanying rule for section 13(f)[59] of the Exchange Act, Rule 13f-1,[60] requires, however, that "[e]very institutional investment manager which exercises investment discretion with respect to accounts holding section 13(f) securities . . . having an aggregate fair market value on the last trading day of any month of any calendar year of at least $100,000,000 shall file a report on Form 13F . . . ."[61] Rule 13f-1 further describes an institutional investment manager as someone "deemed to exercise 'investment discretion' with respect to all accounts over which any person under its control exercises investment discretion."[62]

10, 2007, at C2 (explaining that a hedge fund manager closed one of his funds after a large investor redeemed its capital).

56. Collins, *supra* note 47 ("It's one thing when speculators gamble with their own money; it's another when they turn U.S. energy markets into a lottery where everybody is forced to gamble with them." (quoting Senator Carl Levin (D-Mich.), chairman of the PSI) (internal quotations omitted)).

57. *See, e.g.*, *U.S. SEC Steps Up Probe of Hedge Fund Trading*, Hedge World Daily News, Sept. 27, 2007, *available at* 2007 WLNR 18976792. Even the self-regulatory organizations (the "SROs") have begun targeting hedge funds. *See, e.g.*, Otis Bilodeau, *NASD Widens Inquiry into Hedge Fund Sales*, Int'l Herald Trib., Feb. 3, 2006, at 15. State regulators have also turned their attention to hedge funds, particularly Connecticut, the home-base of three of the most notorious hedge fund collapses in recent history. *See, e.g.*, Michael Peltz, *Not in My Backyard*, Institutional Investor., Aug. 2006, at 20 (noting that Connecticut Attorney General Richard Blumenthal has been "pushing for broader and tougher oversight of the industry—in particular, for greater disclosure and accountability"). However, it has also been argued that these collapses, LTCM and Amaranth in particular, are not appropriate reasons for the SEC to regulate hedge funds. Nelson, *supra* note 28, at 229 ("[N]either example demonstrates the need for hedge fund regulation because neither potential threat came to fruition; both cases [LTCM and Amaranth] were solved without any serious harm to the economy.").

58. *See generally* SEC Staff Report, *supra* note 30.

59. 15 U.S.C. § 78m(f) (2006).

60. 17 C.F.R. § 240.13f-1 (2008).

61. *Id.* § 240.13f-1(a)(1).

62. *Id.* § 240.13f-1(b). The SEC has specified that:

> An institutional investment manager exercises investment discretion if: (i) the manager has the power to determine which securities are bought or sold for the account(s) under

The requirements of section 13(f) apply to *any* institutional investment manager, whether registered or not, if he or she meets the threshold amount.[63] Therefore, if a hedge fund meets the $100 million threshold, it must be in compliance with Section 13(f) and file a Form 13F report on a quarterly basis. This means that on a quarterly basis, a section 13(f)-compliant hedge fund will disclose the majority, if not all, of its long positions and, therefore, a significant portion of its trading strategy.[64]

B. Legislative History

Section 13(f) was added to the Exchange Act by Congress in the Securities Acts Amendments of 1975.[65] The amendments to the Exchange Act were enacted "to remove barriers to competition, to foster the development of a national securities market system . . . to facilitate the collection and public dissemination of information concerning the holdings of and transactions in securities by institutional investment managers."[66] According to the first SEC Release on section 13(f), in 1968 Congress had

> directed the Commission to make a study and investigation of the purchase, sale, and holding of securities by institutional investors of all types, in order to determine the effect of those activities upon the maintenance of fair and orderly securities markets, the stability of those markets, and the interests of issuers of securities and of the public.[67]

> management; or (ii) the manager makes decisions about which securities are bought or sold for the account(s), even though someone else is responsible for the investment decisions.

SEC, Frequently Asked Questions About Form 13F (May 2005), http://www.sec.gov/divisions/investment/13ffaq.htm [hereinafter FAQ].

63. Pizzani, *supra* note 11.

64. *See* FAQ, *supra* note 62. Short positions are not disclosed on Form 13F. *Id.* In response to the turmoil in the financial markets in the fall of 2008, the SEC issued an emergency order, which requires institutional investment managers who file Form 13F reports to disclose their short sales on a weekly basis on Form SH. *See* Emergency Order Pursuant to section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58591 (Sept. 18, 2008), *available at* http://sec.gov/rules/other/2008/34-58591.pdf; Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Development, Exchange Act Release No. 58711 (Oct. 1, 2008), *available at* http://sec.gov/rules/other/2008/34-58711.pdf. For information about the recent economic turmoil and government response, see, for example, Greg Hitt & Deborah Solomon, *Historic Bailout Passes as Economy Slips Further*, Wall St. J., Oct. 4, 2008, *available at* http://online.wsj.com/article/SB122304922742602533.html. A discussion of this very recent development in the disclosure of short sales and the financial market turmoil is beyond the scope of this note.

65. *See* Securities Acts Amendments of 1975, Pub. L. No 94–29, sec. 10, § 13(f), 89 Stat. 97, 119–21 (1975) (codified at 15 U.S.C. § 78m(f) (2006)).

66. Securities Acts Amendments of 1975, Pub. L. No. 94–29, pmbl., 89 Stat. 97, 97 (1975).

67. Reporting by Institutional Investment Managers, Exchange Act Release No. 13,396, 11 SEC Docket 2092 (Mar. 22, 1977).

Congress passed the amendments at a time when the public was particularly anxious about the influence of large-holding institutional investors on the markets.[68]

The Commission's report concluded, among other things, "that the impact of the institutions had increased significantly since the end of the Second World War," and so Congress decided to implement section 13(f).[69] In 1978, the SEC adopted Rule 13f-1.[70] The basic purpose of section 13(f) and its accompanying rule was "to create in the Commission a central repository of historical and current data about the investment activities of institutional investment managers . . . ."[71] The reporting system that the SEC created through Rule 13f-1 and the instructions to Form 13F were both "designed to improve the body of factual data available and thus facilitate consideration of the influence and impact of institutional investment managers on the securities markets and the public policy implications of that influence."[72]

Since its adoption there have been three significant changes to section 13(f), Rule 13f-1, and the instructions to Form 13F. First, in 1979, the SEC adopted an amendment that changed the frequency of disclosure from annual to quarterly.[73] Although there had been some concern among institutional investment managers about the burden of quarterly disclosure, the SEC found that it was in the best interest of the public and that it did not create an excessive inconvenience for institutional investment managers.[74] Not only were managers concerned about the burden of quarterly disclosure, but some also noted that "more frequent reports would be of utility to block traders . . . ."[75] Such concerns, however, were rejected because the SEC feared that "if quarterly reporting [were] not required . . . such data might be lost altogether thereby creating gaps in the continuous flow of information which may be utilized for future policy decisions."[76]

Second, in 1985, the SEC adopted amendments to the instructions of Form 13F, allowing institutional investors engaged in open risk arbitrage to obtain confidential treatment—that is, delayed public dissemination of the Form 13F reports—by making "two good faith representations" regarding the manager's open risk arbitrage

68. Thomas P. Lemke & Gerald T. Lins, *Disclosure of Equity Holdings by Institutional Investment Managers: An Analysis of Section 13(f) of the Securities Exchange Act of 1934*, 43 Bus. Law. 93, 97–98 (1987).

69. *Id.* at 99–100.

70. *Id.* at 101.

71. Filing and Reporting Requirements Relating to Institutional Investment Mangers, Exchange Act Release No. 14,852, 1978 WL 196605 (June 15, 1978) [hereinafter June 1978 Release].

72. *Id.* Another objective of the reporting system was to create "uniform reporting standards and a uniform centralized data base." *Id.*

73. Filing and Reporting Requirements Relating to Institutional Investment Mangers, Exchange Act Release No. 15,461, 16 SEC Docket 687 (Jan. 5, 1979).

74. *Id.*

75. *Id.*

76. *Id.*

positions to the SEC.[77] If the institutional investment manager made these representations, he or she would automatically be granted confidential treatment for one year.[78]

Third, in 1999, the SEC adopted another amendment to section 13(f), requiring the institutional investment managers to file their Form 13F disclosures electronically via the SEC's EDGAR system.[79] According to the SEC, "[t]he public interest in having these reports, along with other filings, available electronically has increased, and the Commission believes that these reports should have the same degree of availability as other Commission filings."[80]

C. Confidential Treatment of Form 13F Reports & FOIA Exemption 4

In accordance with FOIA,[81] the SEC provides institutional investment managers who file Form 13F reports an opportunity to receive confidential treatment.[82] In order to receive this treatment, a manager must make a request pursuant to the Exchange Act Rule 24b-2.[83] Rule 24b-2 applies to any person who "fil[es] any registration statement, report, application, statement, correspondence, notice or other document . . . pursuant to the [Exchange] Act."[84] Under the rule, an applicant must follow certain steps when filing for confidential treatment:

> Such application shall be on a sheet or sheets separate from the confidential portion, and shall contain (i) an identification of the portion; (ii) a statement of the grounds of objection referring to, and containing an analysis of, the applicable exemption(s) from disclosure under the Commission's rules and

77. Requests for Confidential Treatment Filed by Institutional Investment Managers, Exchange Act Release No. 22,038, 33 SEC Docket 156 (May 14, 1985) [hereinafter May 1985 Release].

78. *Id.* For a more detailed discussion of this amendment, see *infra* Part IV.

79. Rulemaking for EDGAR System, Exchange Act Release No. 40,934, 68 SEC Docket 2814 (Jan. 12, 1999) [hereinafter January 1999 Release].

80. *Id.* The SEC further acknowledged:

> [I]nvestors would find the information contained in Form 13F filings useful in tracking institutional investor holdings in their investments and that issuers, too, would find detail as to institutional investor holdings useful because much of their shareholder list may reflect holdings in "street name" rather than beneficial ownership. Mandatory electronic dissemination of this data will help ensure timely and efficient dissemination of this important information.

Id.; *see also* SEC, Form 13F, http://sec.gov/about/forms/form13f.pdf [hereinafter Form 13F].

81. 5 U.S.C. § 552 (2006).

82. *See* Confidential Treatment Procedures Under the Freedom of Information Act, Securities Act Release No. 584, Exchange Act Release No. 6241, Investment Company Act Release No. 11,354, 20 SEC Docket 1476 (Sept. 12, 1980).

83. 17 C.F.R. § 240.24b-2 (2008).

84. *Id.* § 240.24b-2(a). Form 13F also provides more details of how to request confidential treatment if that treatment is based upon the fact that the information is "confidential, commercial or financial information"; however, Form 13F does not make explicit mention of trade secrets. *See* Form 13F, *supra* note 80, at 1–3.

> regulations adopted under the Freedom of Information Act (17 C.F.R. 200.80), and a justification of the period of time for which confidential treatment is sought; (iii) a written consent to the furnishing of the confidential portion to other government agencies, offices or bodies and to the Congress; and (iv) the name of each exchange, if any, with which the material is filed.[85]

The rule directs an applicant to the SEC's adoption of FOIA rules and regulations. Under the SEC's adoption of FOIA, there are certain records that the SEC will not disseminate to the public.[86] While the SEC is deciding whether to grant confidential treatment, the information will not be released to the public.[87] Although an applicant may ask the SEC to review a negative determination, such review is discretionary.[88] If an applicant does not petition the SEC for review or inform the SEC of his or her intention to institute a court action, the information will be made public five days after the applicant receives notice of the SEC's decision.[89]

Although FOIA provides nine exemptions from public disclosure, the only exemption that is relevant to a manager filing a Form 13F report seeking confidential treatment is Exemption 4, which applies to trade secrets, commercial, or financial information.[90] The instructions to Form 13F explicitly detail how a manager may obtain confidential treatment for commercial or financial information, but in order to receive confidential treatment for a trade secret a manager must meet the relevant FOIA standard.[91] The problem is not only that the FOIA definition of trade secrets

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85. 17 C.F.R. § 240.24b-2(b)(2).

86. *See id.* § 200.80(b) (excluding from disclosure "nonpublic matters"). The rule specifically includes trade secrets as falling under these "nonpublic matters." *Id.* § 200.80(b)(4); *see also* 5 U.S.C. § 552(b)(4) (2006); Lemke & Lins, *supra* note 68, at 114–16. As noted in *Continental Stock Transfer and Trust Co. v. SEC*, the statute and the SEC regulation are parallel exemptions. 566 F.2d 373, 375 (2d Cir. 1977). Therefore, courts deciding upon issues involving this exemption will apply case law on FOIA Exemption 4. *See, e.g.*, Lion Raisins Inc. v. U.S. Dep't of Agric., 354 F.3d 1072, 1079–81 (9th Cir. 2004) (noting that the party moving to make information "confidential" for purposes of the "trade secrets" exemption must "show that there is (1) actual competition in the relevant market, and (2) a likelihood of substantial competitive injury if the information were released"); Nadler v. Fed. Deposit Ins. Corp., 92 F.3d 93, 96 (2d Cir. 1996) (using the same two-part test as the District of Columbia Circuit—namely, the information "must have the effect either (1) of impairing the government's ability to obtain [necessary] information . . . in the future, or (2) of causing substantial harm to the competitive position of the person from whom the information was obtained" (citation omitted)); Sharyland Water Supply Corp. v. Block, 755 F.2d 397, 399 (5th Cir. 1985) (same).

87. 17 C.F.R. § 240.24b-2(c).

88. *Id.* § 201.411.

89. *Id.* § 240.24b-2(e).

90. Lemke & Lins, *supra* note 68, at 116. The exact language of Exemption 4 is: "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. § 552(b)(4).

91. *See, e.g.*, FOIA Appeal of Dooley, FOIA Release No. 186, 56 SEC Docket 472 (Feb. 25, 1994) (denying confidential treatment to certain material because it did not fit within FOIA's exemption for trade secrets) (citing Pub. Citizen Health Research Group v. FDA, 704 F.2d 1280, 1288 (D.C. Cir. 1983)).

is restrictive, but also that the standard used to review a denial of a FOIA exemption is the difficult-to-overcome "arbitrary and capricious" standard.[92]

Enacted in 1966, the "basic purpose of [FOIA] 'is to ensure an informed citizenry, vital to the functioning of a democratic society, needed to check against corruption and to hold the governors accountable to the governed.'"[93] Before FOIA was enacted, "federal agencies [could] withhold information 'in the public interest' or 'for good cause shown,' or on the ground that the person seeking the record was not 'properly or directly concerned.'"[94] The passage of FOIA was largely considered a response to the public's concerns about potential secrecy and manipulation in the government.[95] One problem that is often seen, however, is that because of FOIA "third parties have been able to obtain government files containing information submitted by corporations and individuals who thought that the information would be held in confidence."[96]

Parties who wish to protect information from public disclosure may bring a reverse-FOIA action and attempt to show why the specific information falls into one of the nine exemptions.[97] Reverse-FOIA actions are considered informal adjudications. A court reviewing informal agency adjudications "must hold unlawful and set aside agency action, findings and conclusions found arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[98] The arbitrary and capricious standard greatly differs from the de novo standard that a court applies when it reviews an agency's decision in a regular FOIA request (i.e., when a member of the public requests to access records). Under the arbitrary and capricious standard, the "court has a *very limited basis of review* of an agency's decision and can only determine whether the agency had a rational basis for its decision."[99] In contrast,

92. *See* 5 U.S.C. § 706(2)(a) (2006); *see also, e.g.*, Jos. Schlitz Brewing Co. v. SEC, 548 F. Supp. 6, 8 (D.D.C. 1982).

93. Anderson v. Dep't of Health and Human Servs., 907 F.2d 936, 941 (10th Cir. 1990) (quoting NLRB v. Robbins Tire & Rubber Co., 437 U.S. 214, 242 (1978)); *see also* Lawrence Kaplan, Annotation, *What Constitutes "Trade Secrets and Commercial or Financial Information Obtained from Person and Privileged or Confidential," Exempt from Disclosure Under Freedom of Information Act (5 U.S.C.A. § 552(b)(4)) (FOIA)*, 139 A.L.R. Fed. 225, § 1[a], at § 2[a] (1997).

94. Kaplan, s*upra* note 93.

95. *See* Chrysler Corp. v. Brown, 441 U.S. 281, 285 (1979).

96. *Id.*

97. *See, e.g.*, *id.*

98. Occidental Petroleum Corp. v. SEC, 873 F.2d 325, 337 (D.C. Cir. 1989) (quoting 5 U.S.C. § 706(2)(A) (1986)).

99. Alexander & Alexander Servs., Inc. v. SEC, No. 92-1112, 1993 WL 439799, at *5 (D.D.C. Oct. 19, 1993) (emphasis added); *see also* McDonnell Douglas Corp. v. U.S. Dep't of Air Force, 215 F. Supp. 2d 200, 204 (D.D.C. 2002) ("A reviewing court does not substitute its judgment for the judgment of the agency under the arbitrary and capricious standard of review. Instead, the court simply determines whether the agency action constitutes a clear error in judgment.").

under the de novo standard, the appellate court gives no deference to the district court.[100]

Since the purpose of FOIA is to promote disclosure rather than hinder it, the FOIA exemptions are construed narrowly.[101] As one court noted, "FOIA contains a presumption that records in the possession of federal agencies should be accessible to the public."[102] It is generally accepted that:

> [T]he purpose of exemption 4 . . . is to protect the confidentiality of information submitted to the government . . . . [Some courts] emphasiz[e] the function of insuring privacy or competitive position of the citizen proffering such information, and other [courts] emphasiz[e] the need to encourage cooperation with government by persons having information that is useful to government officials.[103]

A problem that arises with exemption 4, however, is that if disclosure of an alleged trade secret occurs, that trade secret, and the accompanying protection provided by law, disappears. A secret can no longer be a secret if the public is aware of it.[104]

The Restatement (Third) of Unfair Competition defines a trade secret as "any formula, pattern, device, or compilation of information which is used in one's business and which gives him an opportunity to obtain an advantage over competitors who do not know or use it."[105] In *Public Citizen Health Research Group v. FDA*, the Court of Appeals for the District of Columbia held that the Restatement of Torts's definition of trade secrets was not applicable to FOIA exemption 4 because it was too broad.[106] Although Congress did not provide a definition of trade secrets in adopting FOIA,

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100. Salve Regina College v. Russell, 499 U.S. 225, 238 (1991) ("When *de novo* review is compelled, no form of appellate deference is acceptable."); *see also* Rebecca Silver, Comment, *Standard of Review in FOIA Appeals and the Misuse of Summary Judgment*, 73 U. Chi. L. Rev. 731, 736 (2006) ("De novo review is the strictest standard of review, in which the appellate court determines an issue 'anew; afresh; a second time.'").

101. U.S. Dep't of Justice v. Tax Analysts, 492 U.S. 136, 151 (1989); Herrick v. Garvey, 298 F.3d 1184, 1189 (10th Cir. 2002); Abraham Fruchter & Twersky LLP v. SEC, No. 05 Civ. 00039, 2006 WL 785285, at *2 (S.D.N.Y. Mar. 29, 2006).

102. Nat'l Cmty. Reinvestment Coal. v. Nat'l Credit Union Admin., 290 F. Supp. 2d 124, 133 (D.D.C. 2003); *see also* 5 U.S.C. § 552(a)(4)(B) (placing the burden on the agency to sustain its action of withholding agency records).

103. Kaplan, *supra* note 93, § 3.

104. *See, e.g.*, *Herrick*, 298 F.3d at 1193–94; *see also* Restatement (Third) of Unfair Competition § 39 cmt. f (1995) ("To qualify as a trade secret, the information must be secret."). In defining a trade secret, an essential element is that it must be a secret. Therefore, in order to bring an action for misappropriation of a trade secret, many courts require that the claimant have taken reasonable measure to protect the secret. *See, e.g.*, Rockwell Graphic Sys., Inc. v. DEV Indus., Inc., 925 F.2d 174, 175 (7th Cir. 1991).

105. Restatement (Third) of Unfair Competition § 39 (1995).

106. 704 F.2d 1280, 1288 (D.C. Cir. 1983). Prior to the publication of the Restatement (Third) of Unfair Competition in 1995, the Restatement (First) of Torts, published in 1939, was the primary source of modern substantive law of trade secrets. *See* 1 Melvin F. Jager, Trade Secrets Law § 3:2 (2008). For sake of simplicity, the single term "Restatement" will be used hereinafter to refer to both Restatement versions vis à vis the common law definition of trade secrets.

the court reasoned that the intended definition was the common law definition.[107] The court found that for purposes of FOIA a trade secret is "a secret, commercially valuable plan, formula, process, or device that is used for the making, preparing, compounding, or processing of trade commodities and that can be said to be *the end product of either innovation or substantial effort*."[108]

The key difference between the two definitions is that the Restatement only requires that the trade secret *could* provide a competitive advantage to its holder, while the restrictive FOIA definition requires a "direct relationship" between the trade secret and the productive process (i.e., the labor exerted or the innovation used to create the trade secret).[109] In *Public Citizen*, there was precedent citing the Restatement definition, and the Food and Drug Administration ("FDA"), the agency party in the case, had adopted the Restatement definition in its regulations. However, the court stated that since it was "bound by neither the agency's interpretation nor judicial precedent, we feel free to repudiate the broad *Restatement* approach and the FDA's regulation as inconsistent with the language of the FOIA and its underlying policies."[110] The court was especially concerned that an overly broad definition of trade secret would render the second exempted FOIA category of financial or commercial information moot.[111]

IV. AUTOMATIC GRANT OF CONFIDENTIAL TREATMENT SOLUTION

The combination of a restrictive definition of trade secrets and the arbitrary and capricious standard of review creates a substantial burden for a hedge fund manager to overcome when seeking exemption from public dissemination of a Form 13F report. Therefore, more often than not, a hedge fund's trading strategy, and arguably its trade secrets, will be distributed to the public.[112] Moreover, public dissemination of Form 13F reports does not go unnoticed; the reports are used by the public,

107. Although usually "courts could simply assume that Congress intended the term to bear its common law meaning in the absence of evidence to the contrary," with trade secrets it was much more difficult because both broad and narrow definitions existed at common law. *Pub. Citizen*, 704 F.2d. at 1286.

108. *Id.* at 1288 (emphasis added). "This definition, we believe, hews more closely to the language and legislative intent of the FOIA than does the *Restatement* approach." *Id.* at 1289.

109. *See* Anderson v. Dep't of Health & Human Servs., 907 F.2d 936, 944 (1990); Grundberg v. Upjohn Co., 137 F.R.D. 372, 393 (D. Utah 1991) (explaining that "trade secrets should be defined in the narrower common law sense"); 15 Fed. Proc. Law. Edition. § 38:146 (2008) ("Rejecting the broad definition of trade secrets found in the Restatement, the courts have adopted a narrow definition of trade secrets . . . . The narrower common-law definition of trade secret requires that there be a direct relationship between the trade secret and the productive process.").

110. *Pub. Citizen*, 704 F.2d at 1288.

111. *Id.* at 1289 ("If a trade secret can be any information used in a business which gives competitive advantage, then there is little or no information left that could qualify as commercial or financial information under the second category of the exemption without also qualifying as a trade secret.").

112. *See, e.g.*, Gregory Zuckerman, *Edward Lampert Is in the Hunt—Sears Chairman Has Sent Signals He's Looking for Acquisitions—General Motors in His Sights?*, Wall St. J., Sept. 19, 2006, at C1 (describing one prominent hedge fund manager as "one of a small handful" who has received delayed confidential treatment of his Form 13F report).

including competitors, when determining which investments to make or track.[113] By analyzing a hedge fund's Form 13F report, one can determine the type of industry in which the fund is heavily invested,[114] the size of companies in which a fund invests,[115] and the number of shares owned in each such company.[116]

With the proliferation of the hedge fund market and the resulting difficulty in generating strong returns in a more competitive market,[117] a hedge fund's trading strategy, such as its current long positions and the balance thereof, is of crucial importance because it can provide the fund with its competitive edge. The fact that "few hedge funds now make impressive returns for their investors"[118] is arguably

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113. *See* Lemke & Lins, *supra* note 68, at 95–96 (noting that both parties to a merger and acquisition, particularly hostile takeovers, use Form 13F reports "to aid in their planning"); Goldstein Exemption Application, *supra* note 11, at 16–19 (providing examples of "how 13F filings are actually—and illegitimately—used by investors in the real world").

114. *See, e.g.*, Goldstein Exemption Application, *supra* note 11, at 17 ("I'm not going to go over all the positions [listed in an investor's Form 13F] (there are more than 100 of them), and I'm going to focus on [the investor's] largest tech positions. On the whole, it seems [the investor] goes for tech stocks with the following characteristics. . . ." (quoting James Altucher, *Use This Filing to Trade Like Jeff Berkowitz*, Real Money, Mar. 1, 2008, *republished in* TheStreet.com, Mar. 2, 2006, http://www.thestreet.com/comment/investing/10271190.html)).

115. *See, e.g.*, Goldstein Exemption Application, *supra* note 11, at 16 ("This year's cut [of what top mutual fund managers invested in]: 23 funds that mostly own shares of large companies, 21 that like smaller companies and 19 that invest internationally." (quoting Christopher Helman, *Picks of the Pros*, Forbes.com, Jan. 9, 2006, http://www.forbes.com/forbes/2006/0109/064.html)).

116. Goldstein Exemption Application, *supra* note 11, at 16 (quoting Helman, *supra* note 115).

117. *See* Cynthia Futter & Anne E. Wells, *What to Expect from Hedge Funds Today and in the Future: An Overview and Insolvency Perspective*, 29 Cal. Bankr. J. 213 (2007). The authors discussed the future of funds in light of the end of the "liquidity boom":

> What is known is that Funds did not perform better than their mutual fund counterparts in 2006 and this may limit investors' willingness to give them so much capital and pay such high fees. Overall, the Funds returned 12.85% in 2006 while the Standard & Poor's 500 hit 15.8%. The Funds earned an average of only 1% from April to September 2006 . . . . Fund inflows plunged 64% from the third quarter of 2006 to the end of the year, dropping from $44.5 billion in their third quarter to $15.8 billion in the fourth quarter of 2006. . . . Whether fueled by mediocre returns, as compared to the returns in traditional equity markets, or some looming concern about the lack of regulation, the market is clearly slowing the migration of capital away [from] these Funds. Some commentators believe that the trend will continue . . . .

Id. at 234–35; Desmet, *supra* note 33, at 6 ("Since 2002, in fact, hedge funds listed in the Credit Suisse/Tremont Hedge Fund Index underperformed the S&P 500 two out of three years."); Leonhardt, *supra* note 32 ("Last year, the Standard & Poor's 500-stock index jumped 14 percent, while the average hedge fund returned less than 13 percent, after investment fees, according to Hedge Fund Research in Chicago."); *Hedge Funds Slump 1.5 Pct in 1st Qtr -Morningstar*, Reuters, Apr. 17, 2008, http://www.reuters.com/article/companyNews/idUSN1745151920080417 [hereinafter *Hedge Funds Slump*] ("Hedge funds were down an average of 1.5 percent in the 2008 first quarter, their worst quarterly performance in almost four years . . . .").

118. Munk, *supra* note 33, at 130.

linked to their proliferation and the resulting competition among funds.[119] If a hedge fund chooses to keep its trading strategies secret from its investors, it should be able to prevent disclosure of those strategies to the general public.[120]

The SEC has previously modified section 13(f) and the instructions to Form 13F reports in response to certain influxes in highly sensitive business strategies that are deserving of confidential treatment.[121] In a 1984 Release, the SEC solicited comments on its proposal to grant automatic confidential treatment to those engaged in open risk arbitrage positions.[122] The SEC noted that:

> Based on its experience . . . the Commission believes that it should consider whether decisions relating to confidential treatment of information about open risk arbitrage positions can be made without all of the information currently required . . . . Since the potential harm of public disclosure of such positions is identifiable and similar for all open risk arbitrage positions as a class (for example, if a merger which was the subject of risk arbitrage activity was not consummated, an arbitrageur could be harmed when it attempted to liquidate its position in adverse market conditions, if the extent of its position were known to the public), the Commission is proposing [changes to the confidentiality requirements].[123]

After receiving comments on its proposal, the SEC issued another release in 1985, which announced the adoption of the amendment.[124] In order to receive automatic confidential treatment, a manager engaged in open risk arbitrage must make two representations: (1) that the "security holding represents a risk arbitrage

119. There seems to be a correlation between the increase in the number of hedge funds and the decrease in hedge funds' performances. *Compare* Daniel, *supra* note 3, at 248 (citing an increase from 300 hedge funds worth a total of $39 billion in 1990 to 8000 to 9000 hedge funds worth a total of nearly $1 trillion in 2005), Fraidin & Hoverman, *supra* note 38, at 405 (noting SEC Chairman Christopher Cox's estimate that there are nearly 8800 hedge funds managing a total of around $1.2 trillion of assets), Futter & Wells, *supra* note 117, at 214–15 (noting a substantial increase in hedge fund investment dollars), Gibson, *supra* note 20, at 685 (citing an estimate that in 1998 there were 3000 hedge funds, which operated between $200 and $300 billion in capital), *and* MacDonald, *supra* note 15 (stating that there are 351 hedge funds which manage $1 billion or more), *with Hedge Funds Slump*, *supra* note 117 (reporting hedge funds lost an average of 1.5% in the first quarter of 2008).

120. Furthermore, once a trade secret is made public it is no longer a trade secret, and a hedge fund no longer has a private cause of action for any misappropriation of its trade secret by employees or competitors. In order to bring an action for trade secret misappropriation, a claimant must show: (1) that the product or information was not generally known, i.e., it was a trade secret; (2) the claimant attempted reasonable precautions to prevent disclosure of the trade secret; and (3) that the trade secret was acquired wrongly, i.e., misappropriated. Robert P. Merges, Peter S. Menell & Mark A. Lemley, Intellectual Property in the New Technological Age 37 (4th ed. 2006).

121. *See supra* Part III.B.

122. Requests for Confidential Treatment Filed by Institutional Investment Managers, Exchange Act Release No. 21,539, 31 SEC Docket 1052 (Dec. 5, 1984) ("[T]he term 'risk arbitrage' refers to the risking of capital in connection with a proposed merger, acquisition, tender offer, or similar transaction involving recapitalization.").

123. *Id.*

124. *See* May 1985 Release, *supra* note 77.

position that is open on the last day of the calendar quarter for which a [Form 13F] report is filed" and (2) that "the reporting manager has a reasonable belief as of the calendar quarter end that it may not close the entire position on or before the date on which the [Form 13F] report is required to be filed with the Commission." [125]

At the time of the open risk arbitrage amendment, there was a flood of merger and acquisition ("M&A") activity in the markets.[126] One journalist, in surveying the M&A activity of the 1980s, described the decade as follows:

> Talk about thrills and chills, to say nothing of titanic egos and epic greed. The financial civil war that swept across America in the past decade was a ripsnorting string of shoot-'em-ups like nothing ever seen on Wall Street or Main Street. Withering volleys of money shot back and forth as insurgents stormed one entrenched corporate position after another. Counting friendly and hostile deals, more than a third of the companies in the FORTUNE 500 industrials were swallowed up by other concerns or went private.[127]

According to another report, "a towering $1.3 trillion was spent on shuffling assets—an amount on a par with the annual economic output of West Germany" during the 1980s.[128] Although the M&A activity of the 1980s was not always looked upon fondly by commentators, regulators, or academics,[129] like hedge funds today it provided benefits for the financial markets.[130] For example:

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125. *Id*.

126. *See* Lee Hammer, Comment, *Turning a Blind Eye: The Ninth Circuit's Approach to Fraudulent Conveyances and Leveraged Buyouts*, 31 Sw. U. L. Rev. 237, 237 (2002). According to the author:

> More than a decade has passed since the words of Gordon Gecko were forever added to the lexicon of American business practice. "Greed is good" became the calling card for corporate raiders, such as Michael Milken and Ivan Boesky. For ten years, the corporate landscape in the 1980s was littered with leveraged buy-outs, both successes and failures.

Id.; s*ee also* Eugene F. Brigham & Joel F. Houston, Fundamentals of Financial Management 805 (Mike Reynolds et al. eds., Thomson 8th ed. 1998). According to the authors:

> Five major "merger waves" have occurred in the United States. The first was in the late 1800s, when consolidations occurred in the oil, steel, tobacco, and other basic industries. The second was in the 1920s, when the stock market boom helped financial promoters consolidate firms in a number of industries, including utilities, communications, and autos. The third was in the 1960s, when conglomerate mergers were the rage. The fourth began in the 1980s, when LBO [leveraged buy-out] firms and others began using junk bonds to finance all manner of acquisitions. The fifth, which involves strategic alliances designed to enable firms to compete better in the global economy, is in progress today.

Brigham & Houston, *supra*, at 805.

127. Edmund Faltermayer, *The Deal Decade: Verdict on the 80s*, Fortune, Aug. 26, 1991, at 58.

128. Michael O' Neal et al., *The Best and Worst Deals of the 80s*, Bus. Wk., Jan. 15, 1990, at 52.

129. *See, e.g.*, Faltermayer, *supra* note 127; Christopher Farrell et al., *LBOs: The Stars, the Strugglers, the Flops*, Bus. Wk., Jan. 15 1990, at 58 ("Once upon a time, when the Great Depression was a vivid memory, the 'good' company had lots of equity and scant debt. But in the decade of Mike Milken, Kohlberg Kravis Roberts, and Japan, Inc., going deeply into hock became a sign of corporate virility.").

130. *See* Larry E. Ribstein, *Imagining Wall Street*, 1 Va. L. & Bus. Rev. 165, 175 (2006) (comparing what Mikhail Gorbachev sought to do to the Russian economy with his policy of perestroika to what LBO restructurings of the 1980s did to "pave the way for the extended bull market of the 1990s").

> Most 1980s mergers were financial transactions in which buyers sought to buy companies that were selling at less than their true values as a result of incompetent or sluggish management. If a target company could be managed better, if redundant assets could be sold, and if operating and administrative costs could be cut, profits and stock prices would rise.[131]

Under this view, the 1980s M&A activity was a correction to the market's under-pricing of companies that had a higher actual value than was reflected in their stock prices, thus adding value to shareholders by increasing market price and encouraging the optimism that pervaded the market of the 1990s.[132]

Just as there was an abundance of M&A activity in the 1980s, there is a rise in activity in the hedge fund market. As noted, there are between eight and ten thousand hedge funds in existence,[133] which manage approximately $2 trillion in capital.[134] To keep that market vibrant, the SEC should consider adopting another amendment to Rule 13f-1. Like the open risk arbitrage amendment, this proposed amendment would require the requesting manager to make "good faith" representations that the fund's trading strategies not only meet the FOIA standard of trade secrets, but also that the fund has made reasonable precautions to keep its trading strategies secret from the public, including its investors.[135] Like the open risk arbitrage amendment, the SEC could place a limitation on the period of time that confidential treatment would be granted.[136] The requested period of confidentiality should be reasonable and justifiable,[137] and the SEC should solicit comments from institutional investment managers, specifically hedge fund managers, in order to determine the appropriate confidentiality period.[138]

By adopting this proposed amendment, the SEC would still be able to further the principal objectives of section 13(f): to analyze and compile data about the

131. Brigham & Houston, *supra* note 126, at 806.

132. *See* Ribstein, *supra* note 130.

133. Futter & Wells, *supra* note 117, at 215 (predicting there will be more than 11,700 hedge funds by 2008).

134. McDonald, *supra* note 15.

135. As discussed previously, in order to bring an action for the misappropriation of trade secrets, the plaintiff must show that he took reasonable precautions to protect the secrecy. *See* Merges et al., *supra* note 120. For recent cases involving the misappropriation of a hedge fund's trade secrets, see Zimmer v. CooperNeff Advisors, Inc., 523 F.3d 224 (3d Cir. 2008) (involving a trade secret that was a computer model used to rank stocks that the hedge fund may obtain); Bergerson v. Deephaven Capital Mgmt., LLC, No. 03-1090, 2006 WL 305271 (D. Minn. Feb 8, 2006) (involving a hedge fund that claimed that its customer lists were trade secrets).

136. In the open risk arbitrage amendment, the SEC stated that if the two good faith representations were made, then "confidential treatment would be granted automatically for a period of one year." May 1985 Release, *supra* note 77.

137. *Cf.* 17 C.F.R. § 240.24b-2(b)(2) (2008) (requiring "a justification of the period of time for which confidential treatment is sought").

138. The SEC solicited comments on the period of confidentiality for open risk arbitrage positions as well. *See* Requests for Confidential Treatment Filed by Institutional Investment Managers, Exchange Act Release No. 21,539, 31 SEC Docket 1052 (Dec. 5, 1984).

market[139] without disclosing confidential information to the public. This proposed amendment would balance the interest of the public, in that the SEC could still monitor the impact of large-holding institutional investment managers on the market and create policy in response to that impact, with the interest of the private hedge fund managers, who wish to protect their trading strategies from public dissemination.[140]

V. CONCLUSION

Hedge funds have garnered much attention in recent years.[141] Whether it is because of their lack of regulation, the extreme wealth of those who manage them, or their alleged "secrecy,"[142] whenever a large hedge fund collapses, regulators, investors, and commentators furiously turn their attention to the industry.[143] It remains to be seen whether the SEC will be successful in its recent attempts to regulate the hedge fund industry; however, at this moment, many hedge funds that are exempt from registration are still required to produce Form 13F reports to the SEC on a quarterly basis.[144] These reports, which contain a hedge fund's long positions, are then disclosed to the public, unless a hedge fund can successfully obtain confidential

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139. *See* Securities Acts Amendments of 1975, Pub. L. No. 94–29, pmbl., 89 Stat. 97, 97 (1975).

140. Another point to make with respect to section 13(f) and Form 13F Reports is that the purpose of disclosure, as a whole, is to protect the public—that is why securities issued to the public are registered with the SEC. However, the securities laws provide certain exemptions from registration for securities that are offered to accredited investors, i.e., high net worth and sophisticated investors, because those investors are deemed to be of an investment sophistication that does not require the broad protection of the securities laws, and they can measure the risk and benefits of their investments without disclosure. Many of these exemptions are the ones that hedge funds employ to avoid registration because their investors tend to be accredited investors. *See, e.g.*, Desmet, *supra* note 33, at 4 ("Traditional hedge funds have steep investment minimums, from $1 million to as high as $50 million per investor."); Nelson, *supra* note 28, at 229 ("[H]edge fund investors are a small, elite segment of the investing public."). *See generally* James D. Cox, Robert W. Hillman & Donald C. Langevoort, Securities Regulation: Cases and Materials 289–322 (5th ed. 2006) (discussing the Regulation D exemption).

141. *See supra* Part II.

142. *See, e.g.*, Matthew Goldstein, Note, *A Secret Society: Hedge Funds and Their Mysterious Success*, 6 J. Int'l Bus. & L. 111 (2007).

143. *See supra* Part II.C.

144. The fact that, as a whole, hedge funds are not registered is important to the argument regarding confidential treatment of Form 13F reports. If a hedge fund is registered with the SEC, it is required to make many other disclosures regarding its business and therefore, attempting to gain confidential treatment of its Form 13F reports would be moot. *See generally* Cox et al., *supra* note 140, at 1128–29 (discussing the registration exemptions under the Investment Company Act used by hedge funds to gain exempt status). Unlike hedge funds, mutual funds are investment vehicles that are regulated by the SEC under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2006), and the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21. *See* Nelson, *supra* note 28, at 223. Because mutual funds are regulated by the SEC, they are transparent investment vehicles, meaning they are subject to disclosure requirements. Therefore, the benefit of an automatic confidential treatment of their holdings is unnecessary. *See* Nelson, *supra* note 28, at 231. Furthermore, it is important to note that although hedge funds do have a large amount of capital to invest, "hedge funds hold far fewer assets than mutual funds." *Id.* at 226.

treatment through the use of FOIA exemption 4. In order to obtain confidential treatment, however, a hedge fund has an almost insurmountable burden to overcome because of the strict trade secret definition as well as the standard of review employed by the courts.

An automatic grant of confidential treatment provided to a hedge fund manager who represents that his or her holdings are FOIA trade secrets would help remedy this burden. This automatic treatment is of particular importance to hedge funds because of their proliferation and recent difficulty in the continued production of strong returns.[145] In the past, the SEC has amended its Form 13F instructions to allow those engaged in open risk arbitrage the opportunity to receive automatic confidential treatment; thus, there is precedent within the rule itself to give hedge funds such treatment. If the SEC does not address this issue, there is a risk of more litigation regarding this regulation.[146]

145. *See, e.g.*, Donna Kardos, *Survey of Hedge Funds Finds 35% Lost Assets*, Wall St. J., Sept. 9, 2008, at C4 (noting that a "survey of the largest U.S. hedge-fund firms showed that 35% of them lost assets in the first half of the year, putting the growth rate at 4.3%, the lowest in six years").

146. *See* sources cited *supra* note 11 and Part II.A.