2008

An Artifact of Law: U.S. Prohibition of Retail Hedge Funds

Houman B. Shadab
New York Law School

An artifact of law: U.S. prohibition of retail hedge funds

Houman B. Shadab
Senior Research Fellow, Regulatory Studies Program, Mercatus Center, George Mason University[1]

Abstract

The U.S. hedge fund market is one of the largest and most sophisticated hedge fund markets in the world, yet due to U.S. securities regulation it is also one of the least accessible. In the U.S., federal securities law requires individuals to be wealthy to qualify to invest in hedge funds. Nonwealthy individuals, or retail investors, are effectively prohibited from purchasing hedge fund securities. Wealth-based qualifications are meant to ensure that those investing in hedge funds possess enough financial sophistication to make informed investment decisions. However, the application of wealth-based qualifications to hedge fund investors is more an artifact of the specific regulatory framework under which the funds operate than a reflection of any fundamentally unique economic characteristics of the funds. Hedge funds possess risk and disclosure characteristics comparable to a wide range of investment opportunities that U.S. retail investors are currently permitted to invest in and also typically make disclosures sufficient for retail investors to make informed investment decisions. Limiting hedge funds only to the wealthy prevents financially sophisticated yet nonwealthy investors from using the funds to minimize losses and maximize the risk-adjusted returns of their investment portfolios. To more fully advance the regulatory goals of investor protection and capital formation, U.S. financial regulators should therefore enact reforms to permit retail investors to invest in hedge funds.

1 This article is based in part on research published in Shadab, H., 2008 "Fending for themselves: creating a U.S. hedge fund market for retail investors," 11, New York University Journal of Legislation and Public Policy 251. The author would like to thank Massimiliano Trovato for his invaluable research assistance. All errors belong to the author alone.

U.S. law makes a clear distinction between wealthy investors (which includes high net worth individuals and highly capitalized institutions) and ordinary individuals, who are often referred to as retail investors. This distinction is manifested in a dichotomy in the U.S. hedge fund market. On the one hand, the U.S. has the largest and oldest hedge fund market in the world. Approximately half of the world's hedge funds assets are based in the U.S. alone, as are the overwhelming majority of the largest funds which have over U.S.$1 billion in assets[2]. On the other hand, due to U.S. securities regulation, its hedge fund market is also far less accessible to the general public than many other jurisdictions.

U.S. securities law requires investors to be wealthy to legally qualify to invest in hedge funds. For individual investors, this means earning at least U.S.$200,000 in annual income if single (U.S.$300,000 in annual income if married) or having a net worth of at least U.S.$1 million. U.S. law also prohibits hedge funds from making any communications with the public, even if they otherwise do not sell their securities to retail investors. According to a 2007 U.S. Securities and Exchange Commission (SEC) estimate, wealth-based qualifications permit only 8.5 percent of U.S. households to invest in hedge funds[3].

In contrast to the U.S., several regulatory regimes governing well-developed financial markets permit retail investors to have far greater access to hedge funds than their counterparts in the U.S. In Australia, hedge funds that register with the government and make basic disclosures are permitted to market and sell securities to retail investors without any restrictions on their investment activities[4]. Irish law recognizes a category of funds that may invest in hedge funds and are accessible to retail investors without restriction[5]. Spain and Switzerland have also established regulatory frameworks for retail investors to access hedge funds directly or through funds of hedge funds, as have Japan and Singapore[6]. Hong Kong permits retail investors to purchase the shares of hedge funds and funds of hedge funds with investments as small as U.S.$50,000 and U.S.$10,000, respectively[7]. The U.K.'s Financial Services Authority is also currently considering regulatory reforms to allow retail investors greater access to hedge funds. Under U.S. law, however, selling shares to retail investors would prohibit a fund from charging a performance-based fee and substantially restrict the fund's ability to utilize alternative investment strategies — two of the defining features of hedge funds.

Wealth-based qualifications in the U.S. are meant to advance investor protection. From the point of view of the SEC, limiting the class of investors able to invest in hedge funds makes it likely that those who invest in the funds possess a sufficient degree of financial sophistication to make informed investment choices, are able to hire the services of those with enough sophistication, or at least have the ability to bear substantial investment risk. Although wealth-based qualifications may prevent some unsophisticated investors from making uninformed hedge fund investments, several facts about the nature of modern financial markets suggest that SEC policy toward hedge funds generally undermines the interests of U.S. retail investors. Today, U.S. investors are able to invest in a vast and growing array of investments, such as mutual funds that employ hedge fund-like strategies and synthetic exchange-traded funds that track the performance of niche market sectors. These investment products possess comparable risk and disclosure characteristics to hedge funds even though they are subject to the full U.S. securities law regime.

In addition, retail investors that have an interest in hedge funds likely have, either alone or with the assistance of a financial adviser, enough financial sophistication to make investment decisions that reduce the overall risk of their portfolios. Unsophisticated retail investors, by contrast, would likely have no desire to invest in vehicles with which they have little familiarity. In any case, the companies and products unsophisticated retail investors are permitted to invest in are not uniformly safer or less prone to fraud, easier to understand, or even more meaningfully transparent than hedge funds.

The SEC is mandated by law to advance investor protection. Investor protection entails protecting investors from economic losses stemming from fraud and more subtle forms of opportunism by issuers, traders, and other market participants. However, a securities regime does not fully protect investors from losses merely by promoting informed investment decision-making through mandatory disclosure and prohibiting fraud, manipulation, and other types of malfeasance. Investor protection also requires that investors be permitted to invest in a wide range of securities to diversify the risks to their portfolios. Today, due to the explosive growth and integration of global financial markets and rapid financial innovation, even a conservative portfolio of stocks and bonds cannot escape losses stemming from fluctuations in the global capital markets. Investor protection policy must recognize the interconnectedness of the financial markets, since investment losses stemming from investment risk are no less destructive to investor wealth than losses stemming from malfeasance.

Historically, hedge funds have been able to reduce and even eliminate investor losses entirely during general market downturns. Because hedge funds are uniquely able to diversify a portfolio from market risks, the funds not only advance the same goal sought by investor protection regulation, but do so in a way other investment products cannot. Limiting hedge funds only to the wealthy prevents financially sophisticated yet nonwealthy investors from using the funds to minimize losses and maximize the risk-adjusted returns of their investment portfolios. Such a limitation may deprive non-

2 Barth, J.R., and T. Li, 2006, "Hedge funds: risks and returns in global capital markets," December, 13-14; HedgeFund Intelligence, 2008, "Global hedge fund assets rise 27% to $2.6 trillion," April

3 Securities and Exchange Commission, 2007, Prohibition of fraud by advisers to certain pooled investment vehicles; accredited investors in certain private investment vehicles, 72 Fed. Reg. 400, 406 (proposed Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230 & 275)

4 Axiss Australia, 2006-07, "The hedge funds industry in Australia," 13

5 Dillon Eustace Financial Service Group, 2004, "Hedge funds and alternative investment in Ireland," 14-16.

6 PriceWaterhouseCoopers, 2007, "Under the spotlight: the regulation, taxation, and distribution of hedge funds around the globe," June, 37-39; KPMG, 2008, "Japan: regulation, hedge funds"; KPMG, 2008, "Singapore: regulation, hedge funds".

7 PriceWaterhouseCoopers, 2007, "Under the spotlight: the regulation, taxation, and distribution of hedge funds around the globe," June, 25

wealthy investors from having the same opportunities as wealthy investors to save their income and accumulate wealth over time.

Prohibiting hedge funds from selling shares to retail investors is thus an artifact of the U.S. securities regime long rendered obsolete by financial innovation and the maturation of the global investment marketplace. This article proposes reforms to update U.S. law by permitting retail investors to have greater access to hedge funds.

Hedge funds and the retail sector

'Hedge fund' is a label that applies to a very diverse group of investment funds, not all of which technically hedge their investments. Although there is no definition of hedge fund under U.S. securities law, a hedge fund is widely understood to be a type of private investment pool not subject to the full range of restrictions on investment activities and disclosure obligations imposed by the federal securities laws. Hedge funds typically make very frequent trades in securities and financial derivatives, although a significant portion make relatively long-term investments and may do so in investments other than financial instruments. Hedge funds charge a performance-based fee to investors in addition to a fee based upon assets under management. What distinguishes hedge funds from other types of private investment funds is that hedge funds calculate and allocate performance fees to managers on an annual or quarterly basis, even if no investments have been traded (and gains or losses realized).

Performance fees are typically structured with high-water marks, which require that managers first recover any prior losses before a performance allocation can be made. Hedge funds also limit the ability of investors to withdraw capital to a periodic basis (i.e., only at the end of the month or quarter), prohibit investors from transferring shares, and typically institute a lock-up which allows the fund to hold initial capital contributions for a period ranging from one quarter to two years. Hedge fund managers also often invest a substantial portion of their own net worth into the funds they advise, not only to benefit from investment gains, but also to align their incentives with and signal quality to investors. In addition to buying securities to be later sold at a higher price, hedge funds also typically employ investment strategies comprised of trading derivatives, short selling, and using leverage.

As the first decade of the twenty-first century comes to a close, the hedge fund industry displays characteristics typical of a rapidly maturing entrepreneurial sector of the economy. Rapid growth in assets under management and number of funds is perhaps the most noticeable trend in the industry. From 1999 to 2004, the global hedge fund industry nearly doubled in size, growing from an estimated U.S.$456 billion in assets under management to U.S.$973 billion, with the number of funds also approximately doubling to 7,436 from 3,617[8]. By the end of the first quarter of 2008, the hedge fund industry was comprised of approximately U.S.$2.8 trillion in assets managed across an estimated 15,250 separate single-manager funds[9].

Along with the rapid influx of managers and funds has come a decrease in superior risk-adjusted returns, or alpha, reflecting the inherent scarcity of arbitrage opportunities and the widespread diffusion of hedge fund investment strategies. Financial institutions are also playing an increasingly significant, if not wholly dominant, role in the industry. Earlier years were characterized by standalone (or boutique) investment funds providing services to high net worth individuals. Today, large investment banks such as Goldman Sachs and J.P. Morgan routinely sponsor and manage hedge funds, and provide prime brokerage services to a significant share of the industry. Large institutional investors are also increasingly becoming the funds' dominant investor base. Along with institutionalization is increasing sophistication, as hedge funds and their specialized third-party service providers continue to adopt increasingly standardized operating procedures, employ more sophisticated controls, and increase resources committed to risk personnel, operations, and external monitoring[10]. Nonetheless, hedge funds, like other financial institutions, still face significant challenges such as valuing illiquid assets and mitigating the operational risks of over-the-counter derivatives trading.

Outside of the U.S., a niche market is growing within the hedge fund sector to provide services to retail investors. In Australia, for example, high net worth and retail investors together account for approximately two-thirds of the hedge fund market investor base[11]. Other jurisdictions that permit retail access to hedge funds are likely to see greater participation as demand for alternative investment products by retail investors seems to be growing. Nonetheless, even in the absence of regulation, not all hedge funds would seek retail investor clientele. In some non-U.S. jurisdictions, retail investment funds that invest in hedge funds have emerged as the most commercially feasible structure for retail investors to have access to hedge funds.

The U.S. hedge fund legal regime

U.S. hedge funds are primarily governed by the business entity law of the state or off-shore jurisdiction in which they are organized, the law of contract as is applicable to their internal operating agreement and relationships with investors and counterparties, and federal securities law which is promulgated and enforced at the national level. U.S.-based hedge funds are typically organized as limited partnerships or limited liability companies. This structure minimizes the tax liability of the manager and the fund and gives the manager wide-ranging flexibility in managing the fund's internal affairs and carrying out its investment strategy.

8 Counterparty Risk Mgmt. Policy Group II, 2005, "Toward greater financial stability: a private sector perspective, July 27, Appendix B-10.

9 HedgeFund.Net, 2008, "Hedge fund industry asset flow/performance report, first quarter ending March 31, 2008"; HedgeWeek, 2008 "PerTrac study sees increase in hedge fund reporting, but new launches slow," June 3.

10 Mercer Oliver Wyman, 2006, "New study reveals strengthened global hedge fund industry risk management practices and highlights areas for improvement," June 20.

11 Axiss Australia, supra note 4, at 8

Federal law applicable to issuers and investment funds creates a two-tiered structure within which retail investors have virtually no access to hedge funds. U.S. securities laws and regulations do not directly limit investors in their ability to invest in hedge funds. However, hedge funds typically find it essential to their business model to operate without being subject to the full scope of federal regulation that would restrict their investment strategies, impose costly mandatory disclosure requirements, and prohibit their ability to charge a performance fee. To qualify for exemptions from certain federal laws, investment funds must limit their investor base to wealthy individuals and institutions. Accordingly, the choices hedge funds make in response to regulation keep retail investors out of the market.

Four major federal securities laws are applicable to investment funds, and an archetypal hedge fund operates to gain partial exemption from at least three of them by, among other things, not selling its securities to retail investors. The Securities Act of 1933 (Securities Act) governs the conduct of companies raising capital in the U.S. capital markets[12]. It requires issuers of securities to register with the SEC and file a registration statement containing information such as a description of the issuer's business and the risks associated with purchasing its securities. The Securities and Exchange Act of 1934 (Exchange Act) mandates registration and periodic disclosure from issuers (i.e., annual and quarterly reports) whose securities trade in a secondary market on a national exchange[13].

The Investment Company Act of 1940 (Investment Company Act) applies to issuers in the business of investing or trading securities. The Investment Company Act imposes extensive and detailed disclosure requirements on registered investment companies, requires a board comprised of at least 40 percent independent directors, and limits investment companies' ability to utilize leverage, short sales, and derivatives. Hedge fund investment strategies are often centered around the efficient utilization of such techniques. Finally, the Investment Advisers Act of 1940 (Advisers Act) requires that registered investment fund managers disclose information about their general investment strategy, potential conflicts of interest, personnel background, and any financial or legal issue that may prevent the adviser from meeting its contractual commitments to clients. The Advisers Act also generally prohibits registered investment advisers from charging a performance fee to clients.

Hedge funds are exempt from the registration and disclosure requirements of the Securities Act because they do not offer their securities to the public. Rather, hedge funds must make a private placement of securities to select financially sophisticated investors without using any form of widespread advertising or solicitation, and must take steps to prevent resales of their securities. To ensure that the securities offering falls within the scope of a private placement, hedge funds typically limit their securities to accredited investors, which, in the case of individual investors, are defined by law to include only large institutions and individuals earning at least U.S.$200,000 in annual income if single (U.S.$300,000 in joint income if married) or having a net worth of at least U.S.$1 million[14]. Hedge funds gain exemption from the reporting requirements of the Exchange Act in part by limiting the number of investors in each fund to less than 500 persons.

To be exempt from the Investment Company Act, hedge funds can either limit the number of investors in the fund to one hundred, or only allow investors meeting the definition of a qualified purchaser to invest in the fund, which in the case of individuals means the investor must own at least U.S.$5 million in investments[15]. Finally, hedge fund managers seeking exemption from the Advisers Act must qualify as a private adviser, meaning that the manager does not advise more than 15 funds, does not hold itself out to the public, and does not advise a registered investment company[16]. Despite the general prohibition, a registered adviser may nonetheless charge a performance fee if providing services to a fund excluded from the definition of investment company because each investor is a qualified purchaser, or if all investors in the fund meet the definition of qualified client, which includes individuals having at least U.S.$1.5 million in net worth or at least U.S.$750,000 managed by the adviser[17].

Despite being exempt from substantial portions of the federal securities law, hedge funds are still subject to pervasive federal regulation. Hedge funds are subject to the antifraud provisions of the Securities Act and Exchange Act. Even unregistered investment advisers are prohibited from making false or misleading statements regarding their investment strategies, experience, credentials, risks associated with the fund, and valuation of the fund's assets[18]. In addition, hedge funds must disclose significant positions in public company stock. For example, to prevent insider trading the Exchange Act requires hedge funds to make a disclosure when owning 10 or more percent of a company's publicly traded equity securities. To increase information about the investment activities of institutional shareholders, the Exchange Act also requires hedge funds to make a quarterly disclosure of all of their equity holdings if the fund owns more than U.S.$100 million in stock traded on a national exchange or on the NASDAQ[19]. In addition, hedge funds that actively trade certain derivatives may be subject to regulation by the Commodities Futures Trading Commission, and those managing certain types of pension fund assets may be subject to the strictures of the Employee Retirement Income Security Act.

The rationale for wealth-based qualifications

Qualification for the foregoing exemptions depend in large part on a hedge fund selling securities only to wealthy investors who, in case of individuals, must at a minimum meet the definition of an accred-

12 15 U.S.C. §§ 77a-77aa.
13 15 U.S.C. §§ 78a-78nn.
14 Securities Act, Regulation D, 17 C.F.R. §§ 230.501(a)(5)-(6).
15 Company Act § 3(c)(1), 15 U.S.C. § 80a-3(c)(1) (2000); Company Act § 3(c)(7), 15 U.S.C. § 80a-3(c)(7) (2000); Company Act § 2(a), 15 U.S.C. § 80a-2(a)(51)(A)(i) (2000).
16 Advisers Act § 203(b)(3), 15 U.S.C. § 80b-3(b)(3).
17 Advisers Act § 205(b)(4); 15 U.S.C. § 80b-5(b)(4); Advisers Act Rule 205-3(d)(1), 17 C.F.R. § 275.205-3(d)(1).
18 Securities and Exchange Commission, Prohibition of fraud by advisers to certain pooled investment vehicles, 72 Fed. Reg. 44756, 44759 (Aug. 9, 2007) (to be codified at 17 C.F.R. pt. 275).
19 Exchange Act § 16(a)(3)(B); 17 C.F.R. § 240.16a-1; 17 C.F.R. § 240.16a-2 (2007); Exchange Act Rule 13f-1(b); 17 C.F.R. § 240.13f-1(b) (2007).

ited investor under the Securities Act. The rationale behind limiting hedge funds to wealthy investors stems from a fundamental purpose of U.S. securities law, which is to protect investors from being taken advantage of by unscrupulous issuers of securities. These exemptions are based on the premise that being wealthy is an indicator of financial sophistication or otherwise having the ability to bear the type of risks associated with hedge funds. In 2007, the SEC proposed to increase the wealth required to invest in private investment funds to U.S.$2.5 million in investable assets. The SEC explained that substantial wealth hurdles to invest in hedge funds provide an objective and clear standard to use in ascertaining whether a purchaser of a private investment vehicle's securities is likely to have sufficient knowledge and experience in financial and business matters to enable them to evaluate the merits and risks of a prospective investment, or to hire someone who can[20].

The SEC thus considers wealthy investors able to make informed choices about hedge funds because even if they do not possess sufficient financial acumen they are able to purchase the services of persons with financial sophistication, or at least bear losses from poor investment choices. This approach, however, fails to take into account the nature of the modern investment marketplace and the disclosures typically made by hedge funds.

Investment opportunities available to U.S. retail investors

Today, U.S. retail investors can invest in far more than stocks, bonds, real estate, money-market instruments, and other traditional investments. Discount online brokerages allow retail investors to engage in their own trading strategies involving options, futures, and short sales with relatively little upfront capital and without the need to consult a specialized broker. E*Trade Financial, one of the most widely-utilized discount brokerages by American investors, also enables investors through its foreign affiliates to invest in the stock of foreign companies listed on the London Stock Exchange, the Toronto Stock Exchange, the Tokyo Stock Exchange, the Hong Kong Stock Exchange, and Euronext Paris[21]. This includes the shares of publicly listed hedge funds and funds of hedge funds on foreign exchanges.

In addition, exchange-traded funds (ETFs), which are passively managed investment vehicles that track a basket of securities or a price index, provide retail investors with complex investment opportunities in niche market sectors. For example, Proshares offers investors effectively leveraged Ultra ETFs that double the daily performance of general market indices and Short ETFs whose performance is the opposite of a market index such as the Dow Jones Industrial Index and the MSCI Emerging Markets Index. Several issuers offer ETFs that track the value of commodities such as gold, silver, and oil, while some other ETFs track the performance of non-U.S. market sectors such as global healthcare providers, Brazilian stocks, and the bonds issued by emerging market governments.

Perhaps most importantly, innovations in financial products are increasingly presenting U.S. retail investors with new hedge fund-like investments. One development is the growth of hedged mutual funds, which are publicly registered investment companies that mimic hedge fund strategies and only require an average minimum investment of U.S.$5,000, with some as low as U.S.$500[22]. A popular type of hedged mutual fund is a 130/30 fund, which invests 30 percent of its net assets in short positions and uses the proceeds to purchase an additional 30 percent long, thereby resulting in 130 percent long allocation and 30 percent short allocation[23]. Other recent hedge fund-like retail investment products include publicly listed hedge funds or alternative asset managers, such as Fortress Investment Group, Och-Ziff Capital Management Group, and Blackstone Group, all of which went public in the U.S. in 2007[24]. Additionally, there are synthetic hedge fund 'clones' or replicators, which are index-based funds that attempt to replicate hedge fund returns through complex, quantitative trading algorithms[25]. For example, the Goldman Sachs Absolute Return Tracker Fund is open to retail investors and seeks to replicate hedge fund market exposures based upon a proprietary Goldman Sachs hedge fund returns index[26]. ETFs that mimic hedge funds and are accessible to retail investors may also soon be available. For example, Stonebrook Capital is planning to launch an ETF in 2009 that seeks to replicate the returns of a global hedge funds index[27].

All of these investment products are available without restriction to U.S. retail investors. Yet, from the perspective of finance, they possess a level of investment risk, complexity, and transparency that is comparable to that of hedge funds. For example, Proshares' Ultra ETFs and short ETFs achieve their stated investment objectives by employing futures, options, swaps, forwards, and other complex financial instruments. However, the ETFs are not required by law to make specific disclosures about how these financial instruments are specifically utilized, and instead make general disclosures about their mathematical investment methodology, the definitions of such instruments, and the numerous types of risk factors involved[28].

Indeed, because hedge fund-like products pursue alternative investment strategies, they possess the very same risk characteristics and complexities as genuine hedge funds[29]. Retail investors can also use at-home trading platforms in conjunction with access to derivatives and short-sales to pursue any manner of investment strategy on their own, including those employed by hedge funds. Moreover, even investing in U.S. publicly traded companies is complicated by the business operations of companies in a global and information-based economy. For example, the value of securities issued by bulge-bracket banking and financial services conglomerates is

20 Securities and Exchange Commission, supra note 3, at 405.
21 E*Trade Financial, Global Trading 2008
22 Agarwal, V., N. M. Boyson, and N. Y. Naik, 2007, "Hedge funds for retail investors? An examination of hedged mutual funds," June 4, 1; Shell, A., 2006, "Investors add a bit of hedge fund to portfolio mix," USA Today, Dec. 8, B1
23 Brewster, D., 2007, "The long/short show begins," FT.com, Jan. 26
24 AFX News, 2007, "Och-Ziff Capital to follow Blackstone, Fortress IPOs," Forbes.com, Sept, 2
25 Hogan, M., 2006, "Hedge funds: attack of the clones," BusinessWeek.com, Dec. 4; Kat, H. and H. Palaro, 2005 "Hedge fund returns: you can make them yourself!" AIRC Working Paper No. 0023
26 Trincal E., 2008, "Goldman clones HFs for the masses," HedgeWorld, June 17
27 Benjamin, J., 2007, "Hedge funds face potential challenge," InvestmentNews.
28 Proshares Prospectus, 2007, October 1, 6-11
29 Kat and Palaro (2005), Agarwal et al. (2007), Shell (2006)

a function of their multiple business divisions and a wide-variety of risks and developments including inflation, foreign exchange fluctuations, patent acquisitions, the companies' utilization of derivatives and special purpose entities, and legal, accounting, and regulatory developments.

While the disclosures made by complex operating companies, ETFs, and hedge fund-like products provide useful information to investors, any system of mandatory disclosure is inherently limited in its ability to provide retail investors with easily understandable information about the complex factors upon which the value of such companies' shares truly depend. No system of disclosure can prevent retail investors from having to confront substantial, if not overwhelming, complexity in making investment decisions.

Hedge fund disclosures

While investment products open to U.S. retail investors have comparable, if not the exact same, risks and complexities to hedge funds, they share much of the disclosure practices of SEC-registered issuers. Hedge funds make substantial and comprehensive disclosures to comply with the laws they are subject to, comport with industry norms, and satisfy investors. The antifraud provisions of the federal securities laws serve as a form of implied disclosure rule. Because these laws prohibit omissions and misleading statements (in addition to false statements), when a fund makes any disclosures it must make additional disclosures to ensure no statements are later deemed misleading by a court of law or enforcement authorities[30]. In addition, although hedge funds are not required to make all of the same disclosures that are necessary for an SEC registration statement, to gain exemption under the Securities Act the funds must nonetheless disclose the same general type of information.

Accordingly, in practice, hedge funds typically give potential investors a private placement memorandum which describes the fund, its investment objectives, risk factors, its governance structure, and how profits and fees are calculated. Hedge fund disclosures may even be more extensive and investor-friendly than those made by mutual funds, and are certainly far more extensive than the small, closely held companies trading on the Pink OTC Markets, which are available to U.S. retail investors but are not required to make periodic or audited financial statements[31].

In response to the demands of institutional investors, hedge funds are increasingly disclosing information about their investment strategies and operational and risk-management practices. Third parties such as Morningstar are also providing transparency by making information about hedge funds widely accessible and rating their performance. In addition, to the extent the hedge fund market becomes more crowded and returns become more evenly spread throughout the industry, at least some funds are likely to improve their disclosure practices to distinguish themselves from competitors. Indeed, a survey of alternative asset managers found that hedge funds make more frequent disclosures to investors than private equity, real estate, and all other types of surveyed funds[32].

Information disclosed by hedge funds and other parties is therefore sufficient for U.S. retail investors to make informed investment decisions, at least when compared to the multitudes of other investment opportunities available to them. While not all retail investors posses the requisite financial acumen to make informed investment choices about hedge funds or other opportunities currently available to them, those that take the steps necessary to invest in the funds will likely possess the requisite financial sophistication or hire a third party to assist them in decision making. Unsophisticated retail investors are highly unlikely to invest in hedge funds. Research finds that retail investors are typically risk averse, fail to properly diversify their portfolios, and are biased towards investing in companies they are familiar with, even when doing so undermines their economic interests[33].

Increased access to hedge funds is thus highly unlikely to induce unsophisticated retail investors to invest in funds they know little about given that they currently fail to utilize the vast array of widely publicized and low-cost opportunities (i.e., mutual funds, ETFs) already open to them. Retail hedge funds operated by major financial institutions have little incentive to market or sell their shares with promises of exorbitant returns merely to appeal to uninformed investors. Indeed, one result of the credit crisis that began in 2007 is that hedge fund managers will likely make more conservative performance predictions to investors, as even optimistic communications about the general state of the economy may now be grounds for fraud liability.

The benefits of investing in hedge funds for retail investors

The basic lesson of modern portfolio economics is that diversifying the risks to which one is exposed will help to maximize an investor's risk-adjusted returns. Hedge funds tend to be exposed to risks different than those to which traditional investments are exposed, including the risks associated with exposure to overall market fluctuations. This means that investing in hedge funds has the potential to help diversify a portfolio and make retail investors better off. Compared to equity returns, hedge funds' relatively low correlation with fluctuations in the overall market means that the funds can produce absolute returns — gains even while equity returns are negative. From 1994 to 2007, the CSFB hedge fund index indicates that hedge fund returns closely tracked those of the S&P 500 equity index, but did so with far less volatility and correlation with overall market fluctuations[34].

30 First Virginia Bankshares v. Benson, 559 F.2d 1307, 1317 (5th Cir. 1977)
31 Securities and Exchange Commission, Pink Sheets, May 30, 2008
32 PriceWaterHouseCoopers, 2008, "Transparency versus returns: the institutional investor view of alternative assets," March
33 Cao, H. H., B. Han, H. H. Zhang, and D. A. Hirshleifer, 2007, "Fear of the unknown: the effects of familiarity on financial decisions,"; Bailey, W., A. Kumar, and D. Ng, 2006, "Home bias of U.S. individual investors: causes and consequences," Working Paper, Cornell University
34 Jorion, P., "How portfolio transparency can help manage hedge fund risk," J. Financial Transformation 22, 68.

Hedge funds' relatively low correlation with the overall market has thus far remained in tact during the subprime mortgage-initiated credit crisis that began in 2007. Losses from sub-prime-backed securities began to spread to the financial markets generally after the U.S. securities firm Bear Stearns announced on June 22, 2007 that it had bailed out two of its own hedge funds due to losses from investments in such securities. During what may be considered approximately the first year of the credit crunch, from June 1, 2007 through May 30, 2008, the U.S. stock market lost 8.27 percent of its value while hedge funds globally produced gains estimated from 1.83 percent to 4.97 percent, depending on which hedge fund data-set is used and whether a composite index or a diversified funds of hedge funds strategy is considered to be the more truly representative measure of the funds' returns[35].

However, directly comparing hedge fund return figures with those of equities obscures some important differences between them. Hedge funds, for example, may not allow investors to withdraw their capital when desired whereas stock investments can be exited daily in the secondary markets. Furthermore, hedge funds have risk properties that may cause individual funds to have more extreme negative returns than stock or bond investments[36]. Nonetheless, the overall performance of hedge funds since 1994, and especially during the bursting of the Internet bubble and the credit crisis thus far, strongly suggests that retail investors could benefit from allocating some portion of their portfolio to these funds. Indeed, numerous academic studies find that hedge funds can improve the performance of a more traditional stock and bond portfolio[37].

In addition, hedge fund-like investments currently available to retail investors have yet to provide a true alternative to genuine hedge funds. Since going public in 2007, the share prices of U.S. publicly listed alternative asset managers have all produced losses (despite the profitability of their underlying funds). Furthermore, while hedge fund clones may be able to outperform some hedge funds, thus far they have been unable to outperform hedge funds generally[38]. And while hedged mutual funds may outperform traditional mutual funds, they have generally been unable to match the performance of hedge funds[39]. For instance, in the same twelve months leading up to May 2008 analyzed above, a report by EurekaHedge found that long/short equity hedge funds gained 5.62 percent while 130/30 hedged mutual funds lost 2.26 percent[40].

Reforms to create a U.S. retail hedge fund market

U.S. financial regulators generally support the policy of imposing wealth-based qualifications to invest in hedge funds. Indeed, in 2007 the SEC attempted to increase the minimum net worth required to invest in hedge funds to U.S.$2.5 million through a rulemaking procedure that was, ultimately, never finalized[41]. Nonetheless, voices at the SEC have at times expressed a desire to increase hedge fund access to retail investors. For example, in testimony on May 22, 2003 before the House Committee on Financial Services, then Chairman William H. Donaldson noted that "there is a definite need to examine how hedge funds, properly run and properly disclosed, can be allowed to be purchased by retail investors." Based upon the examination in this article, there are several types of regulatory reforms that would enable retail investors to have access to and benefit from hedge funds.

The most straightforward approach would be to permit U.S. investors to have direct access to hedge funds. This would entail substantially reducing or eliminating the wealth-based qualifications required for funds to participate in various securities-related activities. In particular, it would entail substantially reducing the amount of wealth required to meet the definition of accredited investor under the Securities Act so that retail investors could purchase the securities of hedge funds in a private offering. Similarly, it would require substantially reducing the amount of wealth required to meet the definition of qualified purchaser under the Investment Company Act so that retail investors could invest in a private fund. Finally, it would also entail substantially reducing the amount of wealth required to meet the definition of a qualified client under the Advisers Act so that registered advisers could charge performance fees to a fund with retail clientele.

In addition, to enable retail hedge funds to be sufficiently capitalized through raising relatively smaller allocations of funds from retail investors, the 500-investor limitation for companies to be exempt from the reporting requirements of the Exchange Act would also have to be removed or at least dramatically increased. Following the policy of other jurisdictions, the SEC could also enact a compromise reform by removing the wealth-based qualifications for investors in hedge funds that are managed by a government-registered investment adviser.

Another general approach is to allow retail investors greater access to hedge fund investment strategies through a registered investment company. This approach was suggested in a 2003 SEC staff report which concluded that retail investors may benefit if registered investment companies were less restricted by regulation from pursuing hedge fund-like investment strategies[42]. There are two basic types of public investment companies. The first is an

35 The cumulative returns from June 2007 to May 2008, based upon the monthly returns, were 1.83% for the EDHEC Funds of Funds index and 4.97% for the Credit Suisse/Tremont Hedge Fund Index.

36 Brooks, C., and H. Kat, 2002, "The statistical properties of hedge fund index returns and their implications for investors," Journal of Alternative Investments, Fall, 26-44

37 Bacmann, J., and G. Gawron, 2005, "Fat-tail risk in portfolio of hedge funds and traditional investment," in Gregoriou, G. N., N. Papageorgiou, G. Hubner, and F. D. Rouah (eds) Hedge funds: insights in performance measurement, risk analysis and portfolio allocation," John Wiley & Sons Inc.; Cremers, J., M. Kritzman, and S. Page, 2005, "Optimal hedge fund allocations: do higher moments matter?" Journal of Portfolio Management, 29:4, 11–23

38 Hasanhodzic, J., and A. Lo, 2007 "Can hedge-fund returns be replicated?: The linear case," Journal of Investment Management, 5, 19–20; Hogan (2006); Benjamin, J., 2008, "Offering a virtual hedge fund," InvestmentNews, June 9

39 Agarwal et al. (2007)

40 Eurekahedge, 2008, "Absolute return: a comparative review of recent hedge fund performance,"

41 Securities and Exchange Commission (2007). The proposed rulemaking was not finalized likely in part due to the numerous vociferous complaints the SEC received from the public during the comment period.

42 Securities and Exchange Commission, 2003, "Implications of the growth of hedge funds," 104

open-end investment company that sells daily-redeemable shares to investors that do not trade on secondary markets. These companies are often referred to as mutual funds and, in the U.S., comprise over 95 percent of the assets involved with registered investment companies. Another type of registered investment company is a closed-end fund. Closed-end funds offer a fixed number of shares that, unlike mutual funds, trade in secondary markets and are only redeemable at specified time periods.

However, the Investment Company Act limits all registered investment companies from pursuing the full range of investment strategies utilized by hedge funds involving leverage, short sales, and derivatives trading. To use leverage in the form of borrowing bank funds, a registered investment company must cover the debt by retaining assets equivalent to at least 300 percent of the borrowings[43]. Registered investment companies must also offset any short position and certain derivatives positions by a corresponding long position or by holding liquid securities of an equivalent value in a segregated account.[44] Mutual funds in particular are prohibited from employing lock-ups or other investor liquidity-constraining devices. In addition, mutual funds typically adopt relatively narrow long-only investment strategies and lack the flexibility to quickly adapt to changing market conditions because deviating from an investment policy deemed fundamental requires shareholder approval. Each of these limitations on investment companies' activities would need to be substantially reduced or eliminated to permit them to offer investors the full range of benefits associated with hedge fund investing.

A third approach to increasing retail investors' access to hedge funds would be to enact reforms that would afford retail investors the opportunity to invest in a public investment company that in turn invests in underlying hedge funds. In jurisdictions where retail investors have access to hedge funds, it is often through investing in such funds of hedge funds. Besides offering investors the benefits of professional management and diversification of hedge fund investments, funds of hedge funds may also be more attractive from the perspective of hedge fund providers. Hedge funds often find that the optimal investment contributions required, from the perspective of managing a fund, are typically larger than retail investors are able to afford, and would therefore not seek out retail investors even if no regulatory consequences were present. A fund of hedge funds can overcome this limitation by pooling together smaller contributions from retail investors.

However, because the Investment Company Act prohibits mutual funds from investing greater than 15 percent of the net value of their assets in illiquid securities, which includes those typically issued by hedge funds[45], removing this limitation would be required for mutual funds to become the appropriate vehicle for a retail fund of hedge funds. A closed-end fund, on the other hand, has no limitations regarding holding illiquid assets and may therefore be the more appropriate vehicle for establishing a fund of hedge funds for retail investors. Unlike a mutual fund, however, a closed-end fund of hedge funds would likely limit investors' ability to redeem shares as do genuine hedge funds.

Conclusion

Although the U.S. securities law and enforcement regime is rightly considered among the highest quality in the world, SEC regulation of hedge funds is increasingly falling behind that of other jurisdictions with respect to retail investor access. Wealth-based qualifications do not protect retail investors from bearing the risks associated with hedge funds and do not prevent retail investors from investing in a wide range of investments that may be too complicated for their level of financial sophistication. Rather, wealth-based qualifications deprive retail investors of access to the full range of investment products and talents of financial market practitioners and likely have the effect of increasing the risk of retail investors' portfolios.

Although several non-U.S. jurisdictions have embraced the inevitability of an ever-widening and complex array of investment products entering the marketplace, U.S. national regulators have yet to update the U.S. regulatory framework to permit retail investors to invest in hedge funds alongside numerous other comparable investment products. Although investor protection concerns may explain the reluctance of the SEC to ease access to hedge funds, the funds' historical performance relative to that of regulated investment companies and other regulated issuers suggests that failing to permit greater access actually undermines investors' economic welfare — the very goal that investor protection regulation seeks to advance.

43 Company Act § 18(c) (closed-end investment companies), § 18(f) (open-end investment companies).
44 Emerald Management Co., 1978, SEC no-action letter, Jan 21; Lederman, S., 2007, Hedge fund regulation, § 5:2.7, 5-28-29.
45 Investment Company Act Rel. No. 18,612. The SEC defines "illiquid" securities as those that cannot be sold at near their net asset value within seven days. Securities and Exchange Commission, 2003, "Implications of the growth of hedge funds," 105 n.333.