OVERVIEW AND REGULATION OF HEDGE FUNDS

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As the hedge fund industry continues to grow by leaps and bounds, current issues, such as high fees, poor management, and lack of intelligibility, are likely to be resolved.

In this day and age, one cannot take two steps on Wall Street without hearing the “H” word. It almost feels as though not a single economic journal or magazine has gone to print without a feature article pertaining to the new hottest “H” funds and their respective theories. What single sector could have possibly swept the financial world off its feet the way this one has? Call it hedging, hedged funds, hedger, hedgehog, or whatever you like, but, truth be told, the hedge fund appears to have taken over the world and does not appear to be going anywhere in the foreseeable future. What are these funds all about and what could have propelled them onto the pedestal they currently rest upon?

The year was 1949, the analyst was Alfred Winslow Jones, and the birth of the first hedge fund was celebrated. While the modern-day term “hedge fund” is generally associated with a high-risk form of investment, its original connotation was quite to the contrary. It was termed “hedge fund” because of its strategy to hedge market risk by assuming a short position in some stocks while remaining long in others. Jones felt that the combination of hedging his long stock positions by selling short other stocks as means to protect against market risk was a recipe for success. His ingenious model was based on the foundation that performance depends more on better quality stock selection than on a specific market's direction. Jones formed this fund using a limited partnership structure, with the goal of pooling the money of many investors into an unregulated fund that would deliver a higher return than standard mutual funds. His strategies paid off as Jones's hedge fund outperformed the best-performing mutual fund that year by 44 percent, as well as the best five-year performing mutual fund by 85 percent.

As would be expected, Jones's financial formula picked up very strong momentum that has yet to slow down. In 1966, a feature article was written in *Fortune* magazine highlighting Jones's achievements as being responsible for the new investment model that outperformed every mutual fund on the market. Not only did Jones's performance top every other investment in all markets, but it had done so by double-digit numbers. After its acceptance into the financial world as a legitimate investment strategy, the hedge fund market grew rapidly, and by 1968 there had been between 160 and 200 funds established.

Janet Bush for *The New Statesman Journal* wrote that hedge funds really began to take off in the late 1970s, when floating exchange rates and volatile interest rate movements transformed the capital markets and gathered momentum as technology and electronic trading became increasingly quick and sophisticated. [1] By then, the funds were offering a wider array of products and more sophisticated strategies. An additional significant cause for this change was the growing popularity of derivatives, such as futures and options. At that point, even ordinary investors began putting significant amounts of money into hedge funds, and the bull market was delivering record-setting returns.

Despite Jones's proven success, the desire to outperform his success and to maximize returns on an even greater level resulted in many hedge funds focusing on stock-picking coupled with hedging, choosing to engage in riskier strategies based on long-term leverage. The changes from Jones's original method ultimately led to the “hedge” being taken out of hedge funds. The new hedge fund consisted of investment strategies that took both long and short positions (using arbitrage) with buying and selling undervalued securities, trade options, or bonds while investing in almost any opportunity in any market where impressive gains at reduced risk were foreseen.

Currently, hedge funds control an estimated $2.4 trillion in investments, and on many days, their trading accounts for one-third of the volume on major stock exchanges. They have become a major source of profit for nearly all Wall Street bankers and brokers, as every major investment house or private equity firm has either started a hedge fund on its own or with another company, and no self-respecting pension fund or university endowment has holdings not found in hedge fund investments. Gordon Platt, in his article for the *Global Finance Journal*, confirmed that with the hedge fund industry growing as rapidly as it has, investment banks have even joined the party, offering their professional advice and even their own fund of funds to investors. [2] Growth of the hedge fund sector has been so explosive that it is truly unclear how large of an impact it has on the world's, let alone the U.S.'s, investment decision-making. David D. Hale, in an article for *The International Economy* addressing this boom, stated that what has become very clear is hedge funds' impact on profitability, as they typically have turnover rates three times higher than traditional institutions, while representing over 20 percent of daily trading volume. [3] For now, we will just have to sit back and see whether or not hedge funds will be able to continue attracting capital on the large scale they have been supporting.

Hedge fund strategies

Hedge fund strategies vary a great deal, correlating specifically to the many different financial approaches that exist. For example, the event-driven strategy seeks to take advantage of events that are expected to impact the price of a particular stock over a short period of time. Such events as stock buybacks, corporate restructurings, and bond upgrades are likely to have an impact on the market and, in turn, play a role in the performance of any specific fund. While such funds have the potential to earn significantly high returns, as with all event-driven funds, losses could be posted simply if outcome is different than that predicted by the fund's manager. Another type of hedge fund is the fund of funds, which is a hedge fund that invests in other hedge funds, similar to a mutual fund that invests in various stocks. Just as with mutual funds, the key is diversification, diversification, diversification, which can be accomplished by either including funds with different strategies or staying within a single strategy that is spread among various funds employing that strategy. Once again, similar to the classic mutual fund, the advantage of the hedge fund of funds is that it affords investors accessibility to highly successful managed funds whose minimums are too high for the individual investor to delve into. Global funds incorporate the styles involved with investments in equities of different countries. Such funds can include, but are not limited to, investments in predominantly non-U.S. securities purchased based on global economic conditions, investments in emerging countries with less mature financial markets, and investments in established markets such as Europe or Japan. Another hedging style is referred to as “long-only leveraged.” This style seeks to buy and hold securities, hoping to take advantage of growth in their price. Similar to mutual funds, the use of leverage makes this style more risky. Stock selection is generally based on a thorough analysis of a company and on a more technical analysis of the stock's price movements. As a practical matter, long-only funds may use short sales as a hedging technique from time to time. Finally, the macroeconomic style seeks to profit from shifts in global economic trends. This type of fund may invest long or short in various international stock indexes and currencies, and at the same time attempt to take advantage of changes in the relative economic climates among countries. The macro style uses derivatives and leverage extensively, so the risk can be high if the markets perform differently than expected.

Despite the many different varieties of funds and strategies discussed above, there was one quality that actually did remain from Jones's original fund. That one thing was the attempt to reduce volatility and risk while preserving capital and delivering positive returns under all market conditions. However, such aspirations were not always met. Some of the riskier tactics led to heavy losses in 1969–70, followed by a number of hedge fund closures during the bear market of 1973–74. As noted earlier, notwithstanding the weighty losses suffered in the 70s, the following decade brought on a completely new horizon. High-profile money managers abandoned the conventional mutual fund industry, running after the fortune and eminence that was prevalent amongst hedge fund managers.

As will be discussed later in this article, as opposed to mutual funds, hedge funds are not required to register and disclose their asset holdings with the Securities and Exchange Commission. The reason for this is that hedge funds are generally comprised of either offshore corporations or limited partnerships that have a legal limit on the amount of investors. There are many advantages to both of the aforementioned qualities that have attracted investors to the hedge fund market. By investing in offshore funds, investors are afforded the opportunity to minimize their tax liabilities while still being able to invest in the American market. Interests in offshore funds generally cannot be sold or solicited in the United States or to any United States citizen abroad. Not all funds are authorized for sale or exempt from registration or qualification in all countries. The key reason for the funds staying offshore is that gains are either untaxed or very lightly taxed in the country where they are created. Additionally, the regulatory establishment in these countries is less taxing than those where the money managers, promoters, and investors of the fund are located. They are not subject to U.S. income or withholding taxes on distributions received from the fund or to U.S. estate taxes on fund shares and are generally not subject to SEC regulations.

The second of the two types of hedge funds are those of limited partnerships. As with all businesses involving limited partnerships, the organization represents a financial relationship, which generally includes at least one general partner along with a number of limited partners. These partners would normally invest in a specific venture, be it a real estate development or oil exploration or any other investment with the common purpose of benefiting from financial gain. Such an arrangement can be either public, which affords the average person an opportunity to enter the partnership through a brokerage firm, or private. A limited partnership is one in which everyone, excluding the general partners, has limited liability in the investment. This means that the most the limited partners can lose is the total amount they invest. The partnership has a general partner that raises money from investors, who become limited partners. The general partner is responsible for running the fund, including building a staff and investing the fund's assets, and can be held personally responsible for any debts the partnership incurs. Limited partners, in contrast, have no responsibility for making investment or management decisions, and they are not liable for partnership debts. Although the amount one invests is always high and can result in a very hefty loss, the liability is not comparable to that of the general partners, whose losses far exceed that of their original investment.

Advantages and disadvantages of the hedge fund market

As is the case with all investment techniques in every sector, there are many advantages and disadvantages when it comes to investing in any given manner. In that vein, hedge funds too have their positives and negatives. Hedging, unlike other forms of investment, allows for extreme flexibility in investment options. This is because hedge funds use financial instruments that are generally beyond the reach of similar investments, such as mutual funds that have SEC regulations and disclosure requirements that largely prevent them from using short selling, leverage, concentrated investments, and derivatives. Such flexibility allows hedge funds to protect against the downside risk and has resulted in hedge funds' incredible performance throughout their history. Additionally, unlike many mutual fund managers, hedge fund managers are usually heavily invested in a significant portion of the funds they run and share the rewards, as well as the risks, with the investors. Hedge fund managers collect profit from the fund and various incentive fees only when returns are positive, as opposed to mutual funds, where managers collect compensation almost strictly according to the volume of assets managed, notwithstanding any performance history. This incentive fee structure tends not only to attract many of Wall Street's best practitioners and other financial experts to the hedge fund industry, but also places huge incentives for those working in the industry to outperform, as their own wallets are at stake.

Another important benefit hedge fund strategies have is the disassociation of their returns compared to those of the general market. This would serve as an excellent investing alternative to that of traditional investments in stocks, mutual funds, bonds, etc., whose returns are almost entirely affected by those of the market. In turn, rather than being caught in the flow of market fluctuations, hedge funds often take their own course and can remain level, and even positive, during periods of the most dramatic stock market declines. Often, hedge funds prosper even in down markets, as they can profit on the fluctuating spreads in merger arbitrage or between long- and short-term I rates. As proof of this, we can look back to a period in the 1990s when the average return of U.S. stocks fell almost 5 percent during the down periods of the market, while hedge funds actually experienced returns mirroring those of the losses. All too often, the investor is reminded that portfolio diversification is the key to financial stability over any long-term period of time. While the typical concept of diversification includes bonds as well as domestic and international stocks, Benchmark suggests having nearly 40 percent of one's investments in hedge funds and other alternative investments. This is because hedge funds themselves provide the desired diversification and reduce risk by investing in an array of areas such as private equity, commodities, and risk arbitrage or, most importantly, by shorting stocks, something typical mutual funds are restricted from doing by the SEC. Kate Berry of the *Los Angeles Business Journal* cited that while by law hedge funds are restricted to no more than 100 investors per fund and have high minimum entry amounts and fees, wealthy investors were nonetheless captivated by hedge funds when the market crashed, and there was a search for ways to protect capital. [4] An additional attestation that hedge funds can sustain a down market was in 2002 when the S&P 500 was down a grave 22.1 percent, and many hedge funds nonetheless posted not only less significant losses, but even gains. “The industry is growing like gangbusters,” said David Smith, president of Coast Asset Management. He claims that this is very much impacted by the fact that hedge funds are able to produce regardless of stock and bond performance. However, while advantage of diversification may lure someone into hedge funds, Benjamin Deschaine of the *Alternative Investment Management Association Journal* believes municipal bonds serve as a better diversifier against the S&P 500. [5] Although the list runs long with the advantages of hedge fund investment, there are still several prevalent disadvantages that can negatively impact hedge fund investment. Many analysts claim that, as a result of poor expectations in the mainstream stock and bond markets, hedge funds have gained major recognition from those looking to increase returns (specifically brokers who need to satisfy their clientele). These brokers contend that high returns with low risks are sure ingredients for absolute success. William Jahnke, in an article written for the *Journal of Financial Planning*, felt that such claims are simply illusions based on “bad performance data, faulty analysis, and wishful thinking about future prospects.” [6] One of the main reasons for inaccuracies in data is that participation in performance databases is elective, and managers can opt to participate only after a successful period.

Jahnke noted that with the rapid growth in the number of hedge funds, the quality of talented managers is spread too thin, resulting in funds run by inadequate managers. [7] Hedge funds often depend exclusively on the abilities of a fund manager to add value that qualifies the higher level of fees charged and risks incurred. The problem that arises is that there must be a determination as to whether the hedge fund manager actually has financial intelligence or has just been lucky. Some hedge funds invest in private securities offerings and other investments that are difficult to value accurately, so the actual value of the investment may be different than that represented on the periodic statement. Since hedge fund managers usually try to take advantage of inefficiencies in the market, they do not like to publish all of their positions for fear that other hedge funds managers will use this information to trade against them. Since hedge funds do not disclose their history or makeup, and are not required to do so, it is difficult to determine the true abilities of the manager. This leads directly into the second disadvantage: Hedge funds are not as highly regulated by the SEC for reasons stated above. While some consider this to be an advantage, it may certainly be considered a disadvantage in that the common nonprofessional investor will not be aware of greater risks stemming either from poor history, accounting, or fraud. As a way to counter this problem, the SEC is starting to press for more regulation of hedge funds. However, this could also have the effect of pushing more successful and better-qualified managers to move to offshore funds where regulation is still limited.

An unsuspected disadvantage has come to light directly as a result of the poor regulation of hedge funds. Chris Kentouris of the *Securities Industry News* raised a new concern that while data have always been a critical part of any trading operation, hedge funds' heavy demand for information to develop and test their trading strategies and to mark positions has been a bonanza for data vendors and system providers. [8] While most hedge funds have historically focused on gaining exposure through leverage, there are some that are using complex, structured product to achieve alpha. This translates into a requirement of a consistent supply of reliable data across numerous markets. “Data management is one of the most critical modules of the value system for hedge fund managers as they need to take the data from multiple sources in a centralized location,” explained Daniel Abitbol, business development manager for a data supplier. Hedge funds and funds of funds differ in that they obtain their data on the performance of individual hedge funds from benchmarks. However, as the information on performance is voluntarily provided and studies have shown that funds tend to start reporting results only after they have achieved success, those that are losing may never be represented in the database. As a result, for funds of funds, choosing a particular hedge fund entails considerable risk because there is no guarantee of history or future performance.

As mentioned above, hedge funds are limited by law as to the amount of investors (100 including the manager). As a result, minimums for hedge funds are very high (most often beginning with at least a $1 million start-up investment) in order to produce large enough funds to make it worth the manager's time. Such astronomical figures do not allow the common investor to even dream of investing in hedge funds, as it places a tremendous strain even on those who can afford to delve in. Additionally, it is difficult to find a good fund, as they often get closed out quickly because of the limited space.

Even as hedge funds seek to reduce volatility and risk, there is no guarantee that they will be able to do so. This is because most successful managers are unavailable because of the limited investor rule, resulting in many investors putting their money with managers who have limited experience in managing hedge funds. With the use of short trades and leverage, a poor investment can lead to high volatility and large losses. As many managers attempt to take advantage of market inefficiencies, the sudden increase in funds does not represent a stronger market; rather, it translates into additional funds trying to do the same things with the same investment strategies, and as a result, returns will eventually decrease over time. Richard P. Del Bello, managing director and head of equity finance for UBS Investment Bank in New York, maintained that a problem for some hedge funds is that there is too much money seeking to be invested, which leads to greater difficulty in attaining desired rates of return. Resultantly, of the limited quality funds that are around, many are turning people away for fear of becoming too big and losing the ability to chase opportunities for fear of moving markets.

Despite the heavy demand and continually growing popularity of hedge funds, Dan Wheeler, director of global financial advisor services for Dimensional Fund Advisors, in his article for the *Financial Planning Journal*, has his reservations as to whether or not hedge funds are the way to go. While hedge funds often guarantee superior returns that are independent of economic growth and equity market returns, they are often comprised of similar types of securities that are attainable through an ordinary diversified portfolio of funds, and ultimately they play in the same arena as a market portfolio. Additionally, he claims that there is no possible way they can provide greater diversification. [9] The addition of longing 50 percent of holdings while shorting the rest does not enhance levels of diversification; rather, it simply puts one into the casino for securities gambling.

Regulation of hedge funds

As noted earlier in this article and throughout several of the cited articles, there has been an ongoing controversy over what steps, if any, should be taken to protect hedge fund investors and prevent the disastrous results that have taken place in the past, specifically at the turn of the century. Still scarred from the tremendous losses suffered, there have been many appeals to the federal government to take action. Some feel that the most recent downturn was caused by the secretive nature prevalent among hedge fund managers. The investors believe that the funds should be required to disclose their investment practices. Others feel that some of their activities should actually be restricted to protect the investors from the high level of risk involved.

The idea of regulating investment companies began with the rising popularity of mutual funds in the early 1920s. Many new funds were started at this time and investors liked the idea of investing in a well-diversified portfolio. Following the Great Depression, the SEC instituted the Securities Act of 1933 and the Securities and Exchange Act of 1934. The purpose of these acts was to hold companies (specifically investment firms) liable for certain instances of negligence and fraud and to require some level of disclosure, such as issuing a prospectus containing specific information about the fund's management, holdings, fees and expenses, and performance.

In 1940, to further ensure investors' safety, Congress passed the Investment Company Act of 1940, which heightened the standards expected from investment companies. The Act required all who fell under its definition of an “investment company” to register with the Commission and disclose their investment positions and financial condition. Additionally, it placed significant restrictions on the types of transactions they could undertake. For example, they were restricted from trading on margin and from engaging in short sales and were required to secure shareholder approval to take on significant debt or invest in certain types of assets, such as real estate or commodities. Soon after, Congress implemented the Investors Advisement Act of 1940. This Act was intended to complement the Investment Company Act by imposing requirements on the investment advisers as well. Under this Act, any individual who qualifies as an “investment adviser” as defined by the United States Code is required by law to be registered with the SEC and is prohibited from engaging in any fraudulent or deceptive practices. The intention of Congress with the creation of this Act was to keep a census of advisers so the SEC can better respond to and take action on complaints against fraudulent advisers.

Hedge funds, as described by the United States Court of Appeals case *Goldstein v. SEC*, “are notoriously difficult to define.” Rather, “they may be defined more precisely by reference to what they are not.” [10] As a result, they were able to bypass the above-mentioned Act of Congress. The Securities Act of 1933 and the Securities and Exchange Act of 1934 apply only to those companies that are registered with the SEC. The ambiguity of hedge funds has proven to be beneficial for their ability to stay under the radar.

The Investment Company Act of 1940 defines its subjects as any issuer of securities that “is or holds itself out as being engaged primarily… in the business of investing, reinvesting, or trading in securities.” Although this may seem to include hedge funds, most are exempt because they have 100 or fewer beneficial owners and do not offer their securities to the public, or because their investors are all accredited investors (having total incomes of over $200,000 per year or a net worth of over $1,000,000) and qualified purchasers (owning at least $5,000,000 in qualified investments). In a similar vein, the Investment Advisers Act of 1940 defines an investment adviser as one who, “for compensation, engages in the business of advising others, either directly, or through publications or writings, as to the value of securities, or as to the advisability of investing in, purchasing, or selling securities." There are, however, many exceptions listed, including the "private adviser exemption," which exempts any adviser who "during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser, nor acts as an adviser to any investment company registered under [Investment Company Act]." Hedge funds are limited partnerships, and the SEC itself, in the *Safe Harbor Rule*, defined the entire partnership as the adviser's "client." Even the managers of the largest hedge funds would therefore be exempt from the Act via this clause, as most managers run fewer than fifteen hedge funds.

Historically, therefore, hedge funds have opted not to register with the SEC due to the heavy regulations to which they would be subject. Such impositions would affect both the strategies and the performance of hedge funds, as their activities would be limited and their investment tactics would be publicized. For hedge fund managers, the marketability that they sacrifice is a small price to pay, considering the amount of profits they can accrue with their limited market capacity.

In 2003, a joint working group of the major federal financial regulators conducted a study on hedge funds. The decision to do so was based on the tremendous growth of the hedge fund industry and the SEC's lack of information about them. The results of the study were published in a staff report entitled *Implications of the Growth of Hedge Funds*. [11] The staff's primary concern was that hedge funds are not required to have any form of registration, and it is therefore impossible for the SEC to monitor them or obtain any information about them. It is also difficult for them to uncover any fraud or other misconduct until significant losses have occurred. Another key concern was the way the advisers valued the fund's assets (as described earlier). For the aforementioned reasons, the staff recommended that the Commission should consider requiring hedge fund advisers to register as investment advisers under the Advisers Act, taking into account whether the benefits outweigh the burdens of registration. In addition, the staff recommended that the SEC require registered advisers to deliver a disclosure statement to investors. The report explains the benefits of the staff's position. First, registered advisers would be subject to regular inspections and examinations, which could deter fraud and encourage a culture of compliance and control. Second, the SEC would be authorized to collect basic information about the activities of hedge funds and their advisers. Third, registration would allow the Commission to require disclosed information about issues important to investors. And finally, the minimum investment requirement for hedge fund investors would be increased, as registered advisers are prohibited from charging performance fees to investors unless they have $750,000 invested with the adviser, or a net worth of $1.5 million.

The staff maintained that hedge fund managers would not be adversely affected by such a decision, as they would be exempt from the section of the Investment Advisers Act that prohibits the use of certain strategies. Moreover, it would not require the disclosure of hedge fund strategies and portfolio positions, nor would it result in the identification of the funds' investors.

In December 2004, after much heated debate, the SEC, in a narrow three-to-two vote, came out with a final rule entitled *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, informally referred to as the "new Hedge Fund Rule." As is evident by the title, the Commission chose to heed the advice of its staff and ruled that hedge fund advisers are indeed to be included in the Advisers Act. The SEC cited three recent shifts in the hedge fund industry to justify the need for increased regulation. First, between 1999 and 2004 alone, the industry has grown an estimated 260 percent. Second, they noticed a trend of "retailization" of hedge funds that increased the exposure of ordinary investors to the funds. This was caused by the creation of the "fund of hedge funds" industry, which allows investors to inadvertently have a stake in hedge funds without the high minimum investment requirements, and increased investments in hedge funds by pension funds, universities, foundations, and other charitable organizations. Third, there had been an increase in the number of fraud actions brought against hedge funds. They declared that "in the last five years, the Commission has brought 51 cases in which [it has] asserted that hedge fund advisers have defrauded hedge fund investors or used the fund to defraud others in amounts [its] staff estimates to exceed $1.1 billion."

The ruling made clear that the decision would not require hedge fund managers to follow or avoid any particular investment strategies. The SEC therefore refuted any claims that their examination authority will impose undue burdens or interfere significantly with their operations. Further, the SEC maintained that the growing number of hedge fund advisers that are currently registered voluntarily are themselves evidence against the credence of this argument. As stated above, hedge fund managers avoided the Advisers Act by means of the exemption of advisers with fewer than fifteen investors. The Hedge Fund Rule addresses this difficulty, saying that the exemption clause "was designed to exempt advisers whose business activities are too limited to warrant federal attention." Accordingly, allowing hedge fund managers to rely on it would certainly be contradictory to its original intent. The Commission has therefore reevaluated the traditional understating of the word "client," saying that it refers not to the fund as a whole, but to its individual investors.

Many disagreed with this ruling and its factual predicates, foremost being the two dissenting commissioners. They argued, as quoted by the case *Goldstein v. SEC*, “[i]f Congress employs a term susceptible of several meanings, as many terms are, it scarcely follows that Congress has authorized an agency to choose *any* one of those meanings.” Both the Commission and the opposition attempted to bring proofs to their respective understanding of “client” from the language used by Congress itself and from various Supreme Court rulings.

Phillip Goldstein, co-owner of investment advisory firm Kimball and Winthrop, brought the argument to the United States Court of Appeals and petitioned for a review of the case. The case brought up every proof brought by the Commission, along with their refutations. The court decided that the Commission had not adequately explained how the relationship between hedge fund investors and advisers justifies treating the former as a client of the latter. Furthermore, the reports showed that the SEC itself enables general partners of limited partnerships to count the partnership as a single client, as mentioned above, and the Hedge Fund Rule specifically describes the change of policy to be the effect of growth in the industry, and *not* of any change in the relationship between hedge fund advisers and investors, and the SEC may not manipulate the meaning of a word in order to accomplish its objective. Additionally, the argument brought in the Hedge Fund Rule that the intent of Congress was to exempt only small-scale operations is not satisfied by the proposed decision of the SEC. Aside from the fact that the Advisers Act has no such implications, changing its definition of “client” would not accomplish its goal, as the amount of investors in a hedge fund is not indicative of the scale or scope of the fund's activities. As a result, the court ruled against the Commission, stating that “the petition for review is granted, and the *Hedge Fund Rule* is vacated, and remanded.” While the court's decision still stands, the controversy has by no means quieted down. On the contrary, just three months after the court ruled, the heated argument was fueled by the collapse of Amaranth Advisors. [12] In addition to the aforementioned cases, Mat Kelly, writer for the *Boston Business Journal*, explained that the catalyst for the stricter monitoring is due largely to the Patriot Act that was instituted after 9/11, which gave the federal government the power to fight any terrorism in any way it deemed necessary. He explained that as money laundering is a deceitful yet smart way for terrorists to stay under the radar, hedge funds will now be required to register with the U.S. treasury. Kelly nonetheless felt that such a registration process is unlikely to lead to further information leaks regarding the details of specific hedge funds. Since the funds often use complex trades in derivatives and short selling, if the public was privileged to such information, a potential shift in market attitudes could result in a need to modify strategies. [13] In what appears to be a comical appeal, Janet Bush of the *New Statesman* states that stronger regulation rulings would not even work, as even regulators have admitted that they do not understand the industry well enough to be able to deal with it. This is because derivatives, which are a large portion of the hedging formula, are traded among very sophisticated financial institutions and individuals who have considerable incentive to use them properly, and in reality the regulators do not have a clue as to what is going on, leaving them powerless to regulate the funds.

Conclusion

When analyzing the topic at hand, regulation has been and always will be frowned upon in our economic society, a society created on the foundation of capitalism. Regulation, historically, is only accepted in instances of utter necessity. As discussed in this article, this has not been deemed to be such an instance, most importantly by the Court of Appeals. Furthermore, hedge funds in their natural state have proven to be a major component in the growth of the economy since the 2000 recession, even with the unfortunate events that took place within certain funds. The SEC itself has, in fact, acknowledged the importance of the hedge fund in our economy, while discussing the issue in its final ruling. Assuming the basic approach of the court, there is not enough evidence that regulating hedge funds is necessary, or that it would be effective at all. And since there is uncertainty on the side of the opposition, the benefits of having hedge funds as non-regulated organizations surely discount any of the aforementioned “necessary” reasons or doubts.

As shown throughout this article, hedge funds have served to be a very valuable asset in the formulation of portfolios because of the diversification they offer and their exclusiveness in respect to conventional bond and stock portfolios. As the hedge fund industry continues to grow by leaps and bounds, current issues, such as high fees, poor management, and lack of intelligibility, are likely to be resolved. In an article written in *The Journal of Financial Planning* by Mitchell D. Eichen, the author felt that with the market evolving as strongly as it has, “[c]ompetition, a difficult market environment, increased institutional participation, and added regulatory scrutiny will promote the evolution of emerging managers with niche strategies who are best positioned to provide superior investment performance.” However, there are opposing views as to what the future holds for hedge funds. Former chairman of the U.S. Federal Reserve Alan Greenspan stated at a conference of bankers in Beijing that “[a]fter its recent very rapid advance, the hedge fund industry could temporarily shrink, and many wealthy fund managers and investors could become less wealthy.” Greenspan did, however, feel that if banks manage their credit risks efficiently, then necessary adjustments should not really stand as a threat to financial stability. For now, only time will tell whether or not the hot trend in the hedge fund industry will continue. Alfred Winslow Jones was out to accomplish one feat: to find a new formula to earn more than the traditional methods. He definitely succeeded, and for as long as investors yearn for portfolio growth, the hedge fund will be around to help achieve those goals.

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