HEDGE FUNDS AND PUBLIC DISCLOSURE REQUIREMENTS: IS THE SEC TELLING SECRETS?

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I. INTRODUCTION

Although hedge funds are often perceived as secretive, section 13(f) of the Securities Exchange Act of 1934 requires many hedge fund managers to publicly disclose their equity holdings. As this Note will demonstrate, such a disclosure requirement could be construed as a taking of private property, in violation of the Fifth Amendment, thus becoming another barrier to the Securities and Exchange Commission’s attempts to regulate the hedge fund industry.

The hedge fund industry has experienced significant growth in recent years. The Securities and Exchange Commission (“SEC”) reported, in 2004, that there were approximately 7000 hedge funds operating in the United States, managing approximately $870 billion in assets.1 In early 2007, the hedge fund industry had grown into a $1.4 trillion industry.2 The rapid growth of hedge funds has been coupled with concerns that the hedge fund industry is largely unregulated.3 Many of these concerns followed the high profile collapse of Long Term Capital Management4 in 1998 and regained momentum in 2006 when Amaranth Advisors5 lost roughly $6 billion; both of these events have

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drawn the investment world’s attention to the federal government’s regulatory approach to hedge funds.\textsuperscript{7}

In September 2003, the SEC released its much anticipated Staff Report, titled the “Implications of the Growth of Hedge Funds,”\textsuperscript{8} citing the industry’s growth and the SEC’s own lack of information on hedge funds as its primary basis for conducting the Report’s underlying study.\textsuperscript{9} In October 2004, the SEC concluded that its current regulatory program for hedge fund advisers was inadequate.\textsuperscript{10} The SEC subsequently moved to increase its regulatory efforts by proposing a new rule that would require hedge fund advisers, managing at least $25 million in assets, to register with the SEC so that it could gather information about hedge funds, oversee hedge fund advisers, and deter or detect fraud by unregistered advisers.\textsuperscript{11}

The SEC met strong opposition in its efforts to implement the more stringent hedge fund regulation.\textsuperscript{12} Among those who opposed the new rule were two dissenting SEC Commissioners, Alan Greenspan, and numerous representatives from the hedge fund industry.\textsuperscript{13} Despite the resistance that the SEC faced at the adoption stage, it promulgated the new regulation, requiring most hedge fund managers to register with the SEC, as investment advisers, by February of 2006.\textsuperscript{14} The new rule would have made the hedge fund industry much more transparent because registered investment advisers must, among other requirements, open their record to the SEC upon request.\textsuperscript{15} However, the new rule was almost immediately challenged in the U.S. Court of Appeals for the District of Columbia as arbitrary and an invalid exercise of the SEC authority.\textsuperscript{16} In \textit{Goldstein v. SEC}, the court agreed and vacated the new hedge fund rule.\textsuperscript{17}

The hedge fund industry’s resistance to federal regulation became more apparent when Phillip Goldstein, a hedge fund adviser and the named plaintiff in \textit{Goldstein v. SEC}, indicated that he expects to challenge another SEC rule, section 13(f) of the Securities Exchange Act of 1934, which requires all investment advisers with discretion over $100 million of equity assets to publicly disclose their holdings.\textsuperscript{18} Mr. Goldstein has likened this disclosure requirement to the illegal downloading of music or the theft of Coca Cola’s secret formulas, positing that his fund’s equity holdings constitute a protected trade secret, and


\textsuperscript{10} Adopting Release, supra note 2, at 72,059.

\textsuperscript{11} Id. at 72,063.

\textsuperscript{12} DOUGLAS L. HAMMER ET AL., U.S. REGULATION OF HEDGE FUNDS 6 (2005).

\textsuperscript{13} Id.

\textsuperscript{14} See Adopting Release, supra note 2, at 72,054.


\textsuperscript{16} Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

\textsuperscript{17} Id. at 884.

\textsuperscript{18} Do Hedge Funds Hold ‘Trade Secrets’?, BUS. WK., Sept. 12, 2006, http://www.businessweek.com/investor/content/sep2006/pi20060913_356291.htm?chan=search.
the required disclosure amounts to a taking of property in violation of the Fifth Amendment. 19

This Note examines federal regulation of hedge funds as well as the hedge fund industry’s efforts to avoid federal regulation. This Note also addresses whether an investment adviser’s equity holdings are deserving of trade secret protection and whether the public disclosure mandated by section 13(f) of the Securities Exchange Act constitutes a taking without just compensation. To analyze these questions properly, Part II of this Note provides an overview of hedge funds and the current regulatory framework imposed on hedge funds and their advisers. Part III explores relevant trade secret law and concludes that a reviewing court would be justified in finding that the equity holdings of hedge fund advisers are deserving of trade secret protection. Part IV examines the ramifications of such a finding, if the requirements imposed by section 13(f) were challenged as a taking, and Part V provides concluding remarks.

II. An Overview of Hedge Funds

A. What Are Hedge Funds?

The term “hedge fund” does not have a uniformly accepted definition, but it is commonly used to refer to any professionally “managed pool of assets used to invest and trade in equity securities, fixed-income securities, derivatives, futures and other financial instruments.”20 Although there is no universal definition of a hedge fund, the term has largely been defined by what hedge funds are not and by the regulations to which these asset pools are not subject. 21 The SEC’s 2003 Staff Report defined a “hedge fund as an entity that holds a pool of securities, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act of 1940.”22

Remaining exempt from most federal securities regulations allows hedge funds to engage in very different investing and trading behavior than their mutual fund counterparts. For example, the Investment Company Act prohibits registered investment companies, such as mutual funds, from trading on margin and engaging in short sales, which are core elements of common hedge fund trading strategies.23 Registered investment companies are also required to disclose their investment positions and financial condition to the SEC. 24 Such a

19 Id.
21 Bolter, supra note 8, at 598.
22 Id. (citing STAFF REPORT, supra note 9, at 3). Most hedge funds are exempt from the Investment Company Act’s requirements because they have 100 or fewer beneficial owners and do not offer their securities to the public, or because their investors are all qualified high net-worth individuals or institutions. The Investment Company Act of 1940, 15 U.S.C § 80a-3 (2000).
23 Bolter, supra note 8, at 599.
24 Id. n.17.
requirement makes remaining unregistered attractive to hedge fund managers, especially to those that consider their investment positions to be valuable trade secrets.

B. Organization and Regulation

Most hedge funds are organized as limited partnerships, with each investor taking the position of a limited partner while the fund’s investment adviser is typically the general partner.25 Almost all hedge funds compensate their portfolio managers with a performance fee, based on the returns the manager is able to generate, and with a periodic fee, calculated as a percentage of the fund’s assets.26 The asset-based fee is typically calculated at an annual rate of one or two percent of the fund’s assets, while the performance fee is most often calculated as twenty percent of earned profits.27 “By contrast, the investment adviser to a mutual fund expects to be [compensated] regardless of the mutual fund’s performance.”28

Unlike other investment funds, hedge funds are considerate in their entity selection, size, and offerings in order to remain exempt from registration with the SEC, and “as a result are not constrained by the [Investment] Company Act’s rigid and often obtuse rules [regarding] hedging, leverage and diversification . . . .”29 In addition to the implications regarding trading strategies, avoiding registration with the SEC is what permits hedge fund managers to charge a performance fee for developing successful trading strategies.30

Although unregistered hedge funds are able to utilize more aggressive investment strategies than mutual funds, they do, like the rest of the investing world, come within the scope of most federal securities laws,31 most notably the Securities Act of 1933,32 the Securities Exchange Act of 1934,33 the Invest-

25 Hammer et al., supra note 12, at 3.
26 Id. at 2.
27 Id. (noting that “[t]he asset-based fee is generally viewed as needed to cover the manager’s operating overhead [and] [t]he performance . . . fee . . . is intended to . . . align[] the manager’s interests with those of the investors”).
28 Id. n.4.
29 Id. at 2.
30 Id. at 11.
32 Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2000). The primary objective of the Securities Act of 1933 is to provide full and fair disclosure in securities transactions. Staff Report, supra note 9, at 13. Under the Securities Act, an entity that offers public securities must file a registration statement with the Securities and Exchange Commission. 15 U.S.C. § 77(f). Generally ownership interests in hedge funds fall within the definition of the term “securities” for the purpose of the Securities Act. Staff Report, supra note 9, at 13. However, most hedge funds rely on a “private placement exemption” rather than file a registration statement. Gibson, supra note 4, at 689. To qualify as a private placement and avoid registration under the Securities Act, hedge funds rely on a “safe harbor” provision that permits issuers to sell securities to an unlimited number of “accredited investors” who are considered able to fend for themselves. Staff Report, supra note 9, at 14-15. The term “accredited investor” includes individuals who have a net worth, or joint worth with a spouse, above $1 million or have income over $200,000 in the previous two years, and also includes certain institutional investors with more than $5 million in assets. Id. at 15 (citing Rule 501 under the Securities Act).
ment Company Act of 1940,\textsuperscript{34} and the Investment Advisers Act of 1940.\textsuperscript{35} To an extent, hedge funds are indirectly regulated through the statutory exemptions contained in these acts, which limit their size and availability to certain investors.

C. \textit{Section 13(f) of the Securities Exchange Act of 1934}

Many hedge fund advisers are subject to the quarterly reporting requirements of section 13(f) of the Securities Exchange Act,\textsuperscript{36} the reporting requirement that this Note examines as a possible regulatory taking of property without just compensation.

Section 13(f) was enacted by Congress in 1975 “to increase the public availability of information regarding the purchase, sale, and holdings of securities by institutional investors.”\textsuperscript{37} Section 13(f) applies to all “institutional investment manager[s],” including managers of unregistered hedge funds who exercise investment discretion over accounts with an aggregate fair market value of at least \$100 million.\textsuperscript{38} More specifically, section 13(f) requires that any investment adviser that exercises investment discretion over or owns \$100 million or more in equity securities must report those holdings to the SEC on Form 13F.\textsuperscript{39} In calculating the assets under management, an investment adviser must include all securities portfolios that he or she exercises investment

\textsuperscript{33} Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn. This Act covers all facets of the securities markets and all transactions involving securities trading. Gibson, \textit{supra} note 4, at 691. Several provisions of the Exchange Act either apply directly to hedge funds or indirectly shape hedge funds through exemptions. For example, section 12(g) and Rule 12g-1 of the Exchange Act require that a securities issuer, which includes hedge funds, that has 500 holders of a class of equity security and assets in excess of \$10 million must register the equity security. 17 C.F.R. § 240.12g-1 (2007). Thus hedge funds can avoid registration under this Act by limiting their number of equity holders to 499 investors. \textit{Staff Report}, \textit{supra} note 9, at 18.

\textsuperscript{34} Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64. Hedge funds with less than 100 beneficial owners are exempt from the Investment Company Act. \textit{Id.} § 80a-3(c)(1).

\textsuperscript{35} Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21. Under this Act, investment advisers with fewer than fifteen clients that do not hold themselves out to the public as investment advisers are exempt from registration under the Investment Advisers Act of 1940. \textit{Id.} § 80b-3(b)(3). The Commission considers each fund to be one client for the purposes of this rule; thus the Act’s only practical limitation is to limit the number of funds one person can advise to fifteen or less. Preiserowicz, \textit{supra} note 31, at 817. By not registering under the Advisers Act, a fund manager is not restricted from charging an incentive fee to qualified clients, investors with at least \$750,000 under management and a net worth of \$1.5 million, something that would be prohibited if the fund manager was in fact registered as an investment adviser. \textit{Id.} at 817 & n.63 (citing 17 C.F.R. § 275.205-3(d)(1) (2005)).

\textsuperscript{36} 17 C.F.R. § 240.13f-1(a)(1) (2007).


\textsuperscript{38} \textit{Staff Report}, \textit{supra} note 9, at 20.

\textsuperscript{39} \textit{Hammer et al., supra note 12, at 282 (citing Exchange Act Release No. 40934 (Jan. 12, 1999), 64 Fed. Reg. 2843 (Jan. 19, 1999), and 17 C.F.R. § 240.13f-1(b)). Once an adviser has discretion over \$100 million of equity securities, an initial Form 13F report is due by February 14 of the following year, and a Form 13F filing is required within forty-five days after the end of each calendar quarter thereafter. \textit{Id.}
discretion over, which can even include portfolios held by the adviser’s family members.40

Once a Form 13F has been filed, the SEC is required to make it publicly available, unless the investment adviser applies for, and is granted, confidential treatment. However, the SEC rarely grants confidential treatment.41 The SEC has taken the following position with regard to its obligation to disseminate Form 13F filings publicly:

The wording and legislative history of [Section 13(f)] make clear Congress’ intent that Section 13(f) information be promptly disseminated to the public. Congress also recognized that, in some instances, disclosure of certain types of information could have harmful effects, not only on an investment manager, but also on the investors whose assets are under its management.42 Although an investment adviser, wanting to maintain secrecy as to his or her equity positions, can apply for confidential treatment, the Division of Investment Management for the SEC has taken the position that such requests can only be granted under certain limited circumstances.43

It is the Exchange Act and the Freedom of Information Act (“FOIA”) that provide the requirements under which the SEC may grant confidential treatment for Form 13F information.44 The SEC has declared that confidential treatment is available only in those instances in which an investment manager demonstrates that confidential treatment is in the public’s interest.45 This declaration that confidential treatment is only provided when it is in the public’s interest raises the question of whether the SEC’s procedures for granting confidential treatment sufficiently protect trade secrets. Whether an investment manager’s security holdings actually constitute a trade secret is discussed below in Part III of this Note. The following section describes the SEC’s current process for granting confidential treatment.

D. Confidential Treatment Under Section 13(f)

In adopting section 13(f), Congress specified two categories of securities information that, upon request, should be exempt from section 13(f) disclosure: (1) information that would identify securities held by a natural person or certain estates or trusts; and, most relevant to this Note, (2) “information that would reveal an investment manager’s program of acquisition or disposition that is ongoing both at the end of a reporting period and at the time that the investment manager’s Form 13F is filed.”46 The justification for exempting this second category of information is apparent in the legislative history of section 13(f), which explains that the acquisition or disposition program exemption exists because “[t]he Committee believes that generally it is in the public int-
est to grant confidential treatment to an ongoing investment strategy of an
investment manager. Disclosure of such strategy would impede competition
and could cause increased volatility in the market place.”47 While it seems
clear that Congress was concerned with the harms associated with publicly dis-
closing an ongoing investment strategy, the SEC has not been easily convinced
that these harms exist.

The instructions that accompany Form 13F seek information concerning at
least four elements that the SEC considers particularly relevant to its assess-
ment of an application for confidential treatment for a program of ongoing
acquisition or disposition.48 The SEC requires that applications show (1) the
investment manager has a specific program, (2) the program is ongoing, (3) the
disclosure would reveal the manager’s investment strategy, and (4) the disclo-
sure would result in demonstrable harm.49

Institutional investment managers have found that these requirements are
difficult to overcome, and even Warren Buffet, whose investment strategies are
highly coveted, has been denied confidential treatment.50 The third require-
ment of proving that disclosure would reveal the manager’s investment strategy
is perhaps the most significant hurdle. Under this requirement, an applicant
must demonstrate how the public would be able to discern the manager’s strat-
egy based on public disclosure of his or her purchases or sales of a particular
security.51 What is troubling about this requirement is that, even though a
manager’s specific strategy may not be apparent to the public, his or her strat-
egy can still suffer from the public disclosure of a fund’s holdings. For exam-
ple, an investment manager may have an ongoing strategy of selling off shares
of a specific security over a year’s time. Although the public would be un-
aware of the manager’s exact strategy, the investing public may react to the
manager’s disposition of the security once his or her next Form 13F is dis-
closed. In other words, the manager’s initial sale of the security may act as a
signal to the public that they too should sell the security, triggering a decrease
in its market price. While the public would be unable to discern the manager’s
true strategy, under these circumstances, the manager would still be harmed as
his or her remaining shares of that security would have lost value, solely as a
result of filing a Form 13F. Under these circumstances, had the manager
applied for confidential treatment, such a request would most certainly have
been denied. Here the disclosure would not have enabled the public to discern
the manager’s strategy because the SEC would not have considered this to be a
specific ongoing program of acquisition or disposition. The SEC has taken the
position that “[m]ere indications, however, that a manager’s overall position in
a security had changed during a quarter are, by themselves, insufficient because
this information would not necessarily indicate that the transaction(s) were

added two additional categories of information that are also eligible for confidential treat-
ment: “(1) open risk arbitrage positions; and (2) investment strategies that utilize block
48 U.S. Securities and Exchange Commission, supra note 37.
49 Id.
51 U.S. Securities and Exchange Commission, supra note 37.
made pursuant to a program of acquisition or disposition within the meaning of Form 13F.”

The fact that the SEC has been reluctant to grant confidential treatment requests, in these circumstances and others, has no doubt frustrated many hedge fund managers and encouraged some to challenge section 13(f) as a taking of private property. The remainder of this Note will first examine the question of whether hedge fund holdings are protected property and will then examine the question of whether section 13(f) amounts to a taking.

III. DO HEDGE FUNDS HOLD TRADE SECRETS?

“In many ways, the logic for protecting trade secrets parallels that for protecting patents and copyrights. People will not develop certain forms of information at private cost if the benefits of that information can be immediately socialized by the unilateral actions of others.” However, unlike patents and copyrights, trade secrets are protected primarily by state law. In most states, a “trade secret” is defined as “any information that can be used in the operation of a business or other enterprise and that is sufficiently valuable and secret to afford an actual or potential economic advantage over others.” Under this broad definition, an argument can certainly be made that a hedge fund adviser’s equity holdings constitute a trade secret.

A hedge fund adviser’s investment strategy and holdings reveal the information used in the operation of the fund. Although a fund’s investment strategy is based on publicly available information, the fund’s holdings represent the adviser’s efforts in researching and analyzing publicly available information in order to gain an economic advantage over other market participants. The sufficient value created by these efforts is depicted in the fund’s investment returns and the performance fee paid to the fund’s adviser.

Likewise, an argument can be made that all investment fund advisers, including those of mutual funds, possess trade secrets. However, a trade secret must, first of all, be a secret. Mutual fund advisers are generally required to register with the SEC as investment advisers, which make them subject to numerous disclosure obligations under the Advisers Act. As an example, Adviser Act Rule 206(4) requires registered advisers to disclose their holdings, including the names, dates, and market price of acquired securities, to prospective investors. By choosing to register with the SEC and not take advantage of the numerous exceptions to registration that most hedge funds utilize, mutual fund managers deliberately elect not to keep their holdings and investment strategies secret, which allows free access for others to duplicate the funds’ investments.

On the other hand, hedge fund managers that wish to remain unregistered must consciously do so by complying with several exemptions provided in fed-

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52 Id.
54 Id. at 58.
eral securities laws. The secrecy maintained by many unregistered hedge funds is only thwarted by Rule 13(f) of the Exchange Act once the fund’s adviser has discretion over $100 million dollars in publicly traded securities. If a hedge fund’s assets grow to a value of $100 million or more, the fund’s manager has no choice but to publicly disclose the holdings, unless the fund is granted confidential treatment.58

Once a fund adviser’s holdings reach $100 million in value, the initial Form 13F report is not due until February 14 of the following year, and additional Form 13F filings are not required until forty-five days after the end of each calendar quarter thereafter.59 Thus, an argument can also be made that the SEC’s delay in publicly disclosing an adviser’s holdings under 13(f) renders the information disseminated to the public as stale and worthless, due to the volatile nature of equity markets. It may be true that by the time a Form 13F is publicly disclosed, at least some of the information in the filing is no longer valuable to a person or entity that wishes to duplicate the investment strategy of the filer. However, given the diverse and dynamic nature of investment fund trading, it would be impractical to fashion and apply a rule to account for and determine when a fund’s holdings are no longer sufficiently valuable to be considered a trade secret. It would also be unjust to say that the very rule that mandates the public disclosure of a fund’s holdings also renders the information made available to the public worthless and no longer deserving of protection.

The above analysis demonstrates that under the very broad trade secret definition adopted by most states, it would be appropriate for a court to determine that a hedge fund’s holdings and investment strategies are in fact trade secrets, so long as the fund itself maintains secrecy with regard to its holdings and investment strategies.60

IV. TRADE SECRETS AND CONSTITUTIONAL PROTECTION

The United States Constitution’s Takings Clause, found in the Fifth Amendment, provides that “nor shall private property be taken for public use, without just compensation.”61 A complete understanding of this clause requires a court to address four questions: “(1) Has private property been taken? (2) If so, was there some justification for that taking under the police power? (3) If not, was the taking for a public use? And (4) if so, has just compensation been provided?”62

A. Has Property Been Taken?

In 1984, the U.S. Supreme Court held, in Ruckelshaus v. Monsanto Co., that trade secrets are property under Missouri law and thus protected by the
Takings Clause of the Fifth Amendment. The Court went on to analyze whether a taking occurs when the Environmental Protection Agency (“EPA”) requires pesticide manufacturers to disclose their trade secret information. The Court analyzed the takings question as a regulatory taking, applying the *Penn Central* three-factor test, by examining (1) the character of the government action, (2) its economic impact, and (3) its interference with reasonable investment backed expectations.

No argument was made when the *Monsanto* Court assumed that the challenged government program should be evaluated as a regulatory taking. However, distinguishing between regulatory takings and physical takings is not appropriate when dealing with trade secrets, where the per se rule that is applied in physical occupation cases provides a direct analogy. Cases in which the holder of a trade secret is allowed to continue using the secret himself, but is not permitted to exclude others from its use, are also analogous to partial takings cases, in which the owner of private property is allowed to retain title to property but is required to provide public access to the property. The principal partial takings case is *Kaiser Aetna v. United States*.

In *Kaiser Aetna*, the Supreme Court held that the government had committed a physical taking when it required the owner of a private marina to provide open access to all individuals who had access to public waters. The hallmark of property was said to lie in the right to exclude others, which was compromised when state action turned the private marina into common property. Although this was a partial taking, because title to the marina property was retained, the obligation to compensate the owner was determined under the virtual per se taking rule that is used in the case of direct government occupation, which should also apply in the area of trade secret takings.

The principal distinction between a regulatory takings analysis and a physical takings analysis is the far lower standard of judicial review applied to regulatory takings. The judicial review applied to regulatory takings is derived from *Penn Central Transportation Co. v. New York City*, which stands for the idea that “so long as the regulated user retains some viable economic use of the property, then he cannot complain of the loss of other sticks in the bundle of rights.” An analogy can also be made between restrictions on the use of trade secrets where, for example, the holder is prevented from using the trade secret in a certain location but is still the only person permitted to use the secret, and zoning restrictions that limit a landowner’s use of property but still permit the

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64 Id. at 1004.
65 Id. at 1005 (citing Penn Cent. Transp. Co. v. New York City, 438 U.S. 104, 124 (1978)).
66 Epstein, supra note 53, at 65.
67 Id. at 62.
68 Id.
69 Id. (citing Kaiser Aetna v. United States, 444 U.S. 164 (1979)).
70 Kaiser Aetna, 444 U.S. at 179-80.
71 Epstein, supra note 53, at 62.
72 Id. at 62-63.
73 Id. at 63.
75 Epstein, supra note 53, at 63.
owner to exclude others from the property. 76 However, regulations that require a trade secret owner to disclose information for public use are the intangible equivalent of state action that amounts to direct occupation of private property. 77 In other words, regulations that require a trade secret owner to turn over information for public disclosure are the intangible equivalent of Kaiser Aetna, where the government mandated that the owner of a marina allow public access. 78 As such, it would be appropriate for a court to apply a per se takings analysis to a section 13(f) challenge, just as the Supreme Court did in Kaiser Aetna. However, because the precedent set by Monsanto provides that trade secret takings fall under a regulatory takings analysis, this Note will proceed under Monsanto and its use of the Penn Central three-factor test as applied to trade secret takings.

B. Section 13(f) as a Regulatory Taking Under Penn Central

1. The Character of the Government Action

The stated justification for implementing section 13(f) is “to increase the public availability of information regarding the purchase, sale, and holdings of securities by institutional investors.” 79 By admittedly making a hedge fund’s holdings available to the public, such a disclosure requirement is intended to create a public use. The current judicial approach to takings claims reasons that if there is any conceivable public benefit from a government action, it should not be enjoined and compensation should not be paid to the property owner. 80 Admittedly, there is a conceivable public benefit from requiring disclosure of institutional investment information to the public. A hedge fund’s investors can benefit directly by using the disclosure as a third party check on the information passed from the fund’s manager to its investors. However, the disclosure requirement also indirectly benefits any other person or entity that wants to duplicate a successful fund’s trading strategies. This indirect benefit should be accounted for in evaluating the character of section 13(f), as it renders a successful investment manager’s efforts and trade secrets less valuable if any and all other fund managers can attract investors and earn a performance fee by mimicking another fund’s strategies.

The government’s justification for section 13(f), informing investors, should be questioned in light of the reality that if hedge fund investors wanted this information they would require it from the funds in which they invest, or they would only invest in funds that agree to provide them with the same information. Thus, the justification for section 13(f) can essentially be carried out through each fund’s internal policies. It would be unreasonable to assume that accredited investors, who are expected to be knowledgeable and sophisticated investors, would trust a fund that does not provide its members with the infor-
mation that they desire. Furthermore, the SEC could still protect the investing public by requiring fund managers to file Form 13F and also protect the trade secrets held by fund managers by keeping all 13F filings confidential.

By providing the public with the ability to copy a fund manager’s investments, section 13(f) arguably has a negative impact on the entire hedge fund market. Hedge fund advisers challenging 13(f) would certainly argue that disclosure, and the loss of the right to exclude others from using their trade secrets, renders those trade secrets worthless and likewise makes their efforts worthless. The value of the fund managers’ efforts and the fees they can earn for their skills and services are likely to be diminished by the disclosure of their holdings. As a result, successful fund managers no longer have the incentive to develop unique and innovative trading strategies, just as artists or inventors would be discouraged from bringing new ideas to the market if there were no legal protection available for their intellectual property.

2. The Government Action’s Economic Impact

Unfortunately for any fund manager seeking to challenge section 13(f) as a taking of his or her property, the Penn Central standard requires that “so long as the regulated [property owner] retains some viable economic use of the property in question, . . . he cannot complain of the loss of other sticks in the bundle of rights.”81 Although 13(f) requires a hedge fund manager to disclose trade secrets, that manager still earns a performance fee by putting the trade secrets to use. The fund manager still has the right to continue using his or her trade secrets, and thus retains some economic use for his or her trade secrets, even though the fund manager’s performance fees are likely to be diminished in the future as a result of filing a Form 13F. Thus under the Penn Central standard, it is difficult to argue that section 13(f) constitutes a taking, given that fund managers retain some viable economic use of their trade secrets.

3. Interference with a Reasonable Investment Backed Expectation

The Court’s opinion in Monsanto was almost entirely dedicated to the third Penn Central factor: a reasonable investment backed expectation, which must be more than a unilateral expectation or an abstract need.82 The Monsanto Court found that the plaintiff, a pesticide manufacturer, could not have had a reasonable investment backed expectation. The Court explained that the plaintiff could not have expected the EPA to keep the submitted data confidential beyond the limits of the statute in effect at that time, adding that the plaintiff was on notice that the EPA was authorized to publicly disclose any data it received at any time, as the statute prescribed.83 Under this reasoning, a court could easily find that hedge fund advisers are on notice that their trade secrets will be disclosed if their securities reach a value of $100 million, as is prescribed in the language of section 13(f). However, the confidential treatment available under section 13(f), discussed above, does provide a basis for hedge

81 Epstein, supra note 53, at 63.
83 Id. at 1008.
fund managers to possess a reasonable investment backed expectation, if the SEC were to agree that hedge funds possess trade secrets.

In *Monsanto*, the Supreme Court also evaluated a six-year period where the statutory scheme in effect gave the submitter the opportunity to protect its trade secrets from disclosure by designating them as trade secrets at the time of submission.\(^8^4\) The Court reasoned that during this period the plaintiff provided data to the EPA with the understanding that its trade secrets were protected, adding that the statute gave explicit assurance that the EPA was prohibited from disclosing publicly any data submitted, if both the submitter and the EPA determined the data to constitute a trade secret.\(^8^5\)

Similarly, the language of section 13(f) authorizes confidential treatment, under the FOIA, when such treatment is in the public’s interest. Exemption 4 of the FOIA protects the owner of trade secrets from mandated public disclosure.\(^8^6\) The *Monsanto* Court’s reasoning can be directly applied to the section 13(f) allowance for confidential treatment. It would be reasonable for a fund manager to expect confidentiality as to his or her trade secrets, based on the confidential treatment provision of section 13(f).

C. Is There Justification for the Taking?

Section 13(f) is intended “to increase the public availability of information regarding the purchase, sale, and holdings of securities by institutional investors.”\(^8^7\) As discussed above, Congress may have a valid justification for protecting hedge fund investors, but publicly disclosing a Form 13F filing is susceptible to judicial scrutiny.

So long as a statute’s stated objective can be met without compromising the content of the trade secret, the statute must provide means that satisfy the dual imperatives of protecting private property and the stated objective.\(^8^8\) Publicly disclosing a fund’s security holdings arguably causes more harm to the one whose efforts generated the information than the resulting benefit the public gains from such disclosures. In addition, the SEC can gather the Form 13F information without making it publicly available, which would protect the fund’s trade secrets, the investors of that fund, and the public if any fraudulent activity was ever detected.

Not only is the justification for section 13(f) weak, but the $100 million threshold within the rule is somewhat arbitrary. Why is a hedge fund manager with $100 million in equity securities under management subject to public disclosure, while a manager with $99 million in equities is not? In fact, this $100 million threshold has not been adjusted for inflation since the rule’s adoption thirty-five years ago, while today’s hedge funds have been known to lose up to $6 billion in a matter of days.\(^8^9\)

\(^8^4\) *Id.* at 1010.

\(^8^5\) *Id.* at 1011.


\(^8^7\) U.S. Securities and Exchange Commission, *supra* note 37.

\(^8^8\) Epstein, *supra* note 53, at 66.

D. Has Just Compensation Been Provided for the Taking?

Assuming a court finds that hedge fund holdings amount to trade secrets and that the disclosure required by 13(f) amounts to a taking, the next questions to be addressed are whether just compensation has been provided and how is just compensation to be measured.

In Phillip Morris, Inc. v. Harshbarger, a First Circuit case, a cigarette manufacturer challenged a Massachusetts ingredient-reporting statute that required brand-by-brand reporting of tobacco additives and permitted public disclosure of the ingredient information. There, the Court specifically rejected the State’s claim that compliance with the disclosure requirement was compensated through an exchange because permitting tobacco companies to continue doing business in the State was granted in return for compliance. Similarly, permitting hedge funds to participate in interstate commerce and invest in publicly traded securities does not compensate for an unconstitutional taking of property rights. The reasoning behind the State’s argument in Phillip Morris is no different than “telling the tobacco companies that if they wish to sell their products within the state of Massachusetts, they must deed over to the state the title to their Boston headquarters.” The same reasoning can be found in 13(f); if a hedge fund manager wishes to develop and use profitable trading strategies, that manager must share his or her strategies with the public. Because a hedge fund’s investment returns and performance fees provide a monetary measure of the value created by a fund’s trade secrets, a court could easily fashion a standard, based on these numbers, for establishing just compensation. Of course, this remedy becomes irrelevant if the SEC determines that the cost of paying just compensation is not worth the benefits gained from mandating section 13(f) disclosure.

V. Conclusion

As the Securities and Exchange Commission pushes for increased regulation of hedge funds, it appears that hedge funds and their advisers will continue to push back and find means to avoid regulation. The next attempt to elude the reach of the Securities and Exchange Commission may find its basis in intellectual property law and the protection afforded by the Constitution’s Takings Clause. Given the broad definition of trade secrets adopted by most states, a hedge fund’s holdings could be found to constitute trade secrets.

Such a holding could find a court faced with the question of whether section 13(f) of the Securities Exchange Act constitutes a taking of private property in violation of the Fifth Amendment. A viable argument could be made that the judicial framework for evaluating takings claims is artificially and inappropriately blurred by distinguishing between regulatory takings and physical takings. An argument can also be made that the proper standard for evaluating takings claims in the case of trade secrets should be the same standard of

90 Phillip Morris, Inc. v. Harshbarger, 159 F.3d 670 (1st Cir. 1998).
91 Id. at 679.
92 Epstein, supra note 53, at 70.
review applied to partial physical takings, and, under that standard, section 13(f) works to take a protected property interest without just compensation.

To avoid litigating this matter, the SEC could concede that certain hedge fund advisers do possess trade secrets and grant them confidential treatment, as provided for in section 13(f). Section 13(f) could also be amended to exclude hedge funds, not from the 13F filing requirement, but from the mandatory public disclosure requirement that may in fact constitute a taking.