Hedge Fund Regulation After Goldstein

Monday, August 14, 2006 --- The United States Court of Appeals for the District of Columbia Circuit’s decision in Goldstein v. SEC vacated the Securities and Exchange Commission’s controversial rule on hedge fund regulation and left the future of hedge fund regulation in limbo. The ruling also left many hedge fund managers who registered pursuant to the rule uncertain about their obligation to stay registered and their ability to deregister.

The strongly worded decision marked the end of SEC Rule 203(b)(3)-2 under the Investment Advisers Act of 1940, but it is unlikely to be the last effort by the SEC to regulate hedge fund managers and their increasingly influential hedge funds.

* The Origin of the Rule *

The Commission adopted Rule 203(b)(3)-2 in response to the growth of hedge funds and the perceived increased risks of hedge fund “retailization” and hedge fund fraud. Then-SEC chairman William Donaldson noted that the regulation was a departure from the Commission’s historic “sit back and see what happens” approach to hedge funds.

The rule required investment advisers to count each owner of a “private fund” in determining whether the adviser exceeds the limit of 14 clients for the purpose of determining the availability of the exemption from registration provided by Section 203(b)(3). Specifically, advisers were required to “look through” each private fund they advised and count as a “client” each investor in the fund, rather than the fund itself, in determining whether the adviser satisfied the 14 or fewer client threshold.

Private funds were defined as companies that (i) would be subject to regulation under the Investment Company Act of 1940, but for, the exception from the definition of “investment company” provided in either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act; (ii) had a permitted redemption period within two years of the date of purchase; and (iii) marketed interests based on advisory skills or expertise of the investment advisers to such funds.

The effect of the rule was to require most hedge fund investment advisers who had been relying on the exemption under Section 203(b)(3) to file a Form ADV and register with the SEC. These advisers would then also have to adopt written compliance policies and procedures, maintain certain books and records, appoint a chief compliance officer, and comply with restrictions on charging performance fees. The advisers would also be subject to
surprise inspections and audits by the SEC. Other hedge fund advisers opted to amend their fund documents to remain exempt from registration, such as by implementing two-years plus lock-ups.

The Commission adopted rule amendments to permit investment advisers required to register under the newly adopted rule to continue to market their performance from prior periods, even if they lacked the documentation otherwise required by SEC rules. Other related amendments grandfathered in “performance fee” arrangements with clients who do not meet the definition of “qualified clients”, allowed additional time for completion of audit work on behalf of advisers to funds of funds and amended Form ADV. These grandfathering provisions were not complete in coverage and so newly registered fund advisers still had to amend fund agreements to comply with existing regulations.

The rule’s adoption in 2004 was not without controversy. Comment letters were overwhelmingly against the proposed rule, with many critics questioning the need for such regulation as well as the efficacy. The Commission approved the rule by a three to two vote, with then-chairman Donaldson siding with the Commission’s two Democratic members to approve the rule.

In voting against the rule, Commissioner Glassman suggested as an alternative raising the accreditation standards for investors or requiring registration for funds that allow small investments, while Commissioner Atkins specifically questioned the Commission’s statutory authority to proceed with the rule and characterized the redefinition of “client” as a “tortured end run around the statute.” Commissioners Atkins and Glassman also challenged the necessity of the rule, disputing the SEC’s arguments as to the retailization of hedge funds, and the staff’s need for additional enforcement powers against unregistered investment advisers, as well as the SEC’s ability to effectively police such a large number of advisers with its limited budget.

* The Court’s Decision *

Shortly after the rule’s adoption, it was challenged in the U.S. Court of Appeals for the D.C. Circuit by an investment fund and its manager.

The U.S. Court of Appeals vacated the rule in June 2006, focusing on the Commission’s interpretation of the word “client”. Section 203(b)(3) of the Advisers Act exempts from registration any investment adviser who, among other things, had fewer than fifteen clients during the preceding twelve months, but the Act does not define the term “clients”.

While the Commission argued that this lack of definition rendered the term ambiguous and susceptible to alternate definitions, the Court determined that the meaning of the term needed to be determined in context. The Court noted that the Commission’s historical view was that an investor in a private fund did not receive advice directly from an “investment adviser” (as the investor had made the investment decision when he invested in the fund)
and therefore could not be a “client” of that investment adviser. Additionally, the Court cited prior Commission releases that treated investment pools and limited partnerships as single clients, rather than looking through to the individual investors.

The Court ultimately ruled that even if the Advisers Act did not rule out the Commission’s interpretation, the interpretation fell outside of the bounds of reasonableness. The Court noted that the Commission’s interpretation came close to violating the plain language of the statute and was counterintuitive in characterizing the investors in the hedge fund as “clients” of the adviser. The Court reasoned that such a reading would inevitably create conflicts between the adviser’s fiduciary duty to the fund as a client and to the individual investors as clients.

The Commission’s failure to adequately explain how the relationship justified treating hedge fund investors as clients of hedge fund advisers caused the Court to find that the rule was arbitrary and that the Commission failed to justify departing from its previous interpretation of “client” under Section 203(b)(3).

* The Way Forward *

Hedge funds continue to play an important and increasing role in U.S. financial markets. In testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Chairman Cox noted that hedge funds represent only 5% of all U.S. assets under management, but account for approximately 30% of all U.S. equity trading volume. The SEC admits that the actual size of the hedge fund industry in unknown, but that it appears to represent in excess of $1.2 trillion in assets, and is rapidly growing.

Chairman Cox stated that he intends to recommend emergency rulemaking and actions in the wake of the Goldstein decision. These actions include:

· Issuing a new anti-fraud rule under the Advisers Act that would “look through” a hedge fund to its investors in order to reverse a side-effect of the Goldstein decision that the anti-fraud provisions of Sections 206(1) and 206(2) of the Advisers Act apply only to clients (i.e., the fund), and not to investors.

· Restoring the provision of the rule that allowed for “grandfathering” of performance based advisory contracts for investment advisers who registered under the rule.

· Restoring the qualified exemption from recordkeeping requirements for performance data extended to investment advisers who were required to register under the rule.

· Restoring the extension granted to advisers of funds of hedge funds to provide their audited financial statements.
These actions, aside from the anti-fraud rule, will aid investment advisers who registered pursuant to the rule and would otherwise be unintentionally penalized by the Goldstein decision. Chairman Cox also asked the SEC staff to review the disincentive created by the decision for foreign advisers to register (they now have to worry whether they may be subject to all provisions of the Advisers Act if they remain registered) and to investigate the possibility of increasing the net worth requirement for investors in hedge funds that charge performance fees from $1 million to $1.5 million.

Meanwhile, many of those investment advisers who registered pursuant to the rule are left wondering if they can deregister. They may have held themselves out as registered advisers or taken on more than 14 clients. Others, who adopted longer lock-ups are facing investor pressure to permit accelerated redemption. A recent SEC no-action letter provided guidance on the ability to deregister, but investment advisers who registered will still need to review their specific situations.

The Commission’s decision not to appeal the Circuit Court’s ruling was the correct one. An appeal would have risked an even greater embarrassment and could have raised the bar on future, more reasonable, hedge fund regulations. The SEC will instead propose rules to address the “collateral damage” of the decision and potentially follow up with a change to the net worth test for hedge fund investors (although this change is not supported by all Commissioners).

Chairman Cox has also repeated his call for a new anti-fraud rule. Additionally, he has suggested implementing a “notice and filing” system where fund managers would provide basic information to the SEC that could be reviewed by investors, but would not subject the manager to having its books reviewed by the SEC. This approach squares with Chairman Cox’s stated desire to take formal steps to limit the marketing and availability of hedge funds to unsophisticated retail investors, while also minimizing the potential of overly intrusive legislative or regulatory action.

Letting Rule 203(b)(3)-2 lay in the wake of the Goldstein decision is the best course of action. The investors in the unregulated hedge fund market are large enough, and savvy enough, to mind their own money.

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