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What Happens Now?

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George J Mazin, of Dechert, discusses the ramifications of throwing out the hedge fund adviser registration rule, and its impact on the SEC and the regulatory landscape

What happens now?

The US Court of Appeals for the District of Columbia has vacated the Securities and Exchange Commission (SEC) rule that required more hedge fund managers to register as investment advisers (the Rule). The SEC did so by changing the definition of 'client' for purposes of the private adviser exemption under the US Investment Advisers Act of 1940, as amended (the Advisers Act).

Any investment adviser that has had fewer than 15 clients in the past 12 months may rely on the private adviser

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exemption to avoid registration as long as it does not hold itself out as an investment adviser. For non-US advisers, only US clients must be counted. Prior to the Rule, the SEC had defined a collective investment vehicle (CIS), rather than its owners, as the client for this purpose.

Concerned with the increasing size of the industry, the retailisation of hedge funds, and fraud in the industry, the SEC determined to amend the prior rule to require advisers to look through a fund to count the investors in the fund as clients for purposes of determining compliance with the private adviser exemption. The SEC did this by redefining client to mean the investors in a hedge fund for some, but not all, purposes under the Advisers Act.

In vacating the new rule, the court did not analyse the policy concerns behind the rule change or analyse whether appropriate procedures had

been followed. Rather, the court held the SEC had exceeded its authority to promulgate interpretive rules under the Advisers Act. In the court's view, the look-through rule was arbitrary, strayed too far from the plain language of the statute, and was beyond what Congress intended when it passed the Advisers Act. In particular, the court was concerned the Rule purported to change the definition of client for purposes of the private adviser exemption, but did not apply the same definition to other uses of the term in the Advisers Act. Specifically, the court stated the SEC acted in a manner which appeared to be arbitrary.

As was expected, on 7 August 2006, Christopher Cox, chairman of the SEC, announced the SEC would not appeal the decision of the court.

A bill has been introduced in Congress that would have the effect of reversing the Court's decision, but given the upcoming Congressional elections and apparent lack of interest on the part of the SEC in a legislative solution, the prospect of legislation regarding hedge fund adviser registration is uncertain. Furthermore, based on the draft language of the proposed statute, if enacted it would appear that the SEC would need to readopt the Rule.

On 25 July 2006, chairman Cox, during testimony before the US Senate Committee on Banking, Housing, and Urban Affairs (the Committee), provided a glimpse into some of the actions that the SEC may be considering. Although it is unclear whether hedge fund advisers will be required to be registered at some

point in the future, chairman Cox's testimony provides an interesting insight as to where the Goldstein decision may have left the industry and what the SEC may now be thinking.

It appears the SEC is concerned the court's decision makes regulation and oversight of, and (to a lesser extent) enforcement actions against, hedge fund advisers more difficult. Furthermore, the SEC remains concerned about the retailisation of investment in hedge funds. Balanced against this is the chairman's view "to the maximum extent possible [the SEC's] actions should be non-intrusive". Nonetheless, the chairman noted the SEC planned to undertake certain "emergency rule-makings and other actions to restore as much of the pre-Goldstein rule as possible".

Interim relief

In this regard, it should be noted that on 10 August 2006, the SEC staff issued no action relief to address some of the unintended consequences of the Goldstein decision. This no action letter was issued in response to a request by the subcommittee on Private Investment Entities of the American Bar Association. It was necessary because, as noted in the testimony of chairman Cox, the Goldstein decision had the effect of vacating a variety of related rule changes and interpretative positions included in the final Rule and adopting release.

Among other things, the no action letter provided the following relief:

- Offshore advisers that remain registered may continue to rely on staff guidance as to the substantive provisions of the Advisers Act that are applicable to such advisers



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- The grandfathering provisions in the Rule that permitted advisers to charge performance-based compensation to those investors who invested in a fund prior to 10 February 2005, even if not qualified clients, will continue to be available
- The 180-day time period for a fund of funds to deliver its audited financial statements to investors will continue to be available under the custody rule
- An adviser desiring to withdraw its registration may do so even if during the period of time it was registered it had more than 15 clients and held itself out to the public as an adviser, provided that it is in compliance with the terms of the exemption at the time of the withdrawal. This limited relief will only be available until 1 February 2007.

Future action by the SEC

Chairman Cox informed the Committee, in response to retailisation concerns, he has asked the staff to consider the possibility of increasing accreditation standards as applied to hedge funds. The chairman stated the current standard “is decades old [and] is not only out of date, but wholly inadequate to protect unsophisticated investors from the complex risk of investment in most hedge funds”. Furthermore, the chairman intends to recommend that the SEC promulgates a new anti-fraud rule under the Advisers Act that would have the effect of looking-through a hedge fund to its investors. Such a rule would reverse what chairman Cox described as

a “side-effect of the Goldstein decision that the anti-fraud provisions . . . of the [Advisers] Act apply only to ‘clients’ as the court interpreted that term, and not to investors in the hedge fund.” The rule would, in the chairman’s words “clearly state that hedge fund advisers owe serious obligations to investors in the hedge funds”.

Practical implications

Now that the SEC has announced that it will not appeal the Goldstein decision, hedge fund advisers who registered under compulsion may choose to deregister by filing a Form ADV-W. Before doing so however, managers should carefully consider the reaction of their investors to deregistration, as well as the possibility that registration may again be required if Congress acts in the future.

At the same time, hedge fund managers who registered with the SEC solely because of the rule may nevertheless remain registered. As long as an adviser meets the definition of investment adviser (advising others as to securities for compensation) and has US\$25m (£13.1m) in assets under management or is based outside the US, that adviser may stay registered with the SEC.

Legal implications

In what can only be described as a severe blow to the SEC’s jurisdiction over this area, the court expressed its view that for purposes of the fiduciary duty of advisers under the Advisers Act,

the fund, not the investor, is the client. Thus, for the purposes of the Advisers Act, the adviser owes its fiduciary duties to the fund, not to any particular investor(s).

While the decision does not necessarily settle the issue, it greatly strengthens the position that the fund is the client. Logically, this would suggest that registered advisers need only deliver their disclosure document to the fund, that solicitations of investors for the fund do not fall within the cash solicitation rule, and that any necessary consents to principal or agency cross transactions required by the Advisers Act can be granted by the fund and need not be sought from each investor.

However, advisers should keep in mind there are other sources of fiduciary duty to investors in the fund, such as the anti-fraud provisions of the Advisers Act, ERISA and state law. As mentioned above, chairman Cox plans to direct the SEC to introduce a rule which would reverse the side-effect of the decision that the anti-fraud provisions of the Advisers Act apply only to ‘clients’ as the court interpreted that term, and not to investors in the hedge fund. The SEC could have the rule-making authority for such a rule under Section 206(4) of the Advisers Act, an anti-fraud provision that is not limited to fraud against ‘clients’.

The coming weeks are certain to provide a series of new developments that will affect this ever-changing regulatory landscape.