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A legal update from Dechert's Financial Services Group

Court Throws Out Hedge Fund Adviser Registration Rule – What Happens Now?

Summary

The Court of Appeals for the District of Columbia has vacated rules requiring certain hedge fund managers to register as investment advisers. However, the court's decision has been stayed until August 7, 2006, to give the SEC time to consider whether to appeal or take other actions. Hedge fund managers should consider the practical implications of the court's decision.

Background

The Court of Appeals for the District of Columbia has vacated the Securities and Exchange Commission ("SEC") rules that, among other things, required more hedge fund managers to register as investment advisers by changing the definition of "client" for purposes of the "private adviser exemption" under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act").[1]

Any investment adviser that has had fewer than fifteen "clients" in the last twelve months may rely on the private adviser exemption to avoid registration as long as the adviser does not "hold itself out" as an investment adviser.[2] For non-U.S. advisers, only U.S. clients must be counted. Under the prior regulatory regime, the SEC had, by rule, defined the collective vehicle, rather than its owners, as the client for this purpose. Concerned with the increasing size of the industry, the retailization of hedge funds, and fraud in the industry, the SEC determined to amend the prior rule to require advisers to "look-through" the fund to count the investors in the fund as clients of the adviser for purposes of determining compliance with the private adviser exemption, unless certain conditions were met. 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.[3]

In vacating the rules, the court did not analyze the policy concerns behind the rule change or analyze whether appropriate procedures had been followed. Rather, the court held that the SEC had exceeded its authority to promulgate

1 *See Goldstein et al. v. Securities and Exchange Commission*, Slip Op. No. 04-1434 (D.C. Cir. June 23, 2006). *See also Dechert OnPoint: Court Overturns SEC Hedge Fund Rule* (June 2006).

2 *See* Section 203(b)(3) of the Advisers Act. The Section exempts an adviser from registration if it (i) has had fewer than fifteen clients during the preceding twelve months, (ii) does not hold itself out generally to the public as an investment adviser, and (iii) is not an adviser to any registered investment company.

3 *See* Investment Advisers Act Release No. 2333. *See also Dechert Financial Services Update: SEC Releases Staff Report on Hedge Funds* (October 23, 2003); *Dechert OnPoint: The SEC Proposal to Register Hedge Fund Advisers* (August 2004); *Dechert OnPoint: The U.S. SEC Adopts Rules to Require Hedge Fund Advisers to Register* (October 27, 2004); *Dechert OnPoint: The SEC Publishes Final Rule Requiring Hedge Fund And Certain Other Private Fund Advisers to Register* (January 2005); *Dechert OnPoint: SEC Staff Issues Guidance on New Hedge Fund Adviser Registration Rule* (December 2005); and *Dechert OnPoint: SEC Issues Guidance on Hedge Fund Adviser Rule* (February 2006).

interpretive rules under the Advisers Act.[4] 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 that 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 that the SEC "has, in short, not adequately explained how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter . . . [or] justif[ied the rule] by reference to any change in the nature of the investment adviser-client relationship since [the prior regulatory regime] was adopted. Absent such justification, [the SEC's] choice appears completely arbitrary."[5]

Although the court vacated the look-through rule (as well as all of the other rules passed contemporaneously with the look-through rule, including those which do not address the definition of client), at this moment, the ruling is stayed until as late as August 7, 2006, to give the SEC time to consider its options for appeal. The SEC has announced that it is considering its options with respect to the case and hedge fund regulation in general, but has not made any definitive statement as to whether it intends to appeal the court's decision.

The SEC can seek rehearing by the same court and, regardless of who prevails, the losing party could seek to petition the Supreme Court for review. Few decisions are reversed by the same court on rehearing and the Supreme Court accepts few of the cases that litigants ask it to take. Ultimately, a final judicial determination may take months if there is an appeal. Additionally, since the decision is based on statutory interpretation, Congress could in effect reverse the case through legislation. Indeed, a bill has been introduced in Congress that would have the effect of reversing the case, but the prospect of legislation regarding hedge fund adviser registration is uncertain. Furthermore, based on the draft language of the proposed statute, it would appear that the SEC may need to re-introduce the rules to achieve the same effect.

On July 25, 2006, Christopher Cox, Chairman of the SEC, during testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (the "Committee") on the regulation of hedge funds, provided some insight as to some of the actions that the SEC may be considering. Although it is unclear whether hedge fund advisers will be required to be registered one, three, or even five years from now, it is clear that the SEC intends to regulate the industry, and Chairman Cox's testimony provides interesting insight as to where *Goldstein* may have left the industry.

In this connection, it appears that even if the SEC decides not to appeal, it (or at least its Chairman) is concerned that 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 retailization of investment in hedge funds. Balanced against this is the Chairman's view that "to the maximum extent possible our actions should be non-intrusive."[6] Nonetheless, the Chairman did note that the SEC planned to undertake certain "emergency rulemakings and other actions to restore as much of the pre-*Goldstein* rule as possible."

Chairman Cox informed the Committee that, in response to retailization concerns, he has asked the staff to consider the possibility of increasing accreditation standards as applied to hedge funds. The Chairman stated that 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."[7]

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4 Generally, court decisions overturning rulemaking by administrative agencies do so based on procedural concerns such as whether there was sufficient notice of the proposed rule or whether the comment period was long enough. While some in the industry criticized the length of the comment period, no one made any serious challenge to the process the SEC undertook in making the rule. As was evident from the hedge fund investigation, hedge fund roundtable, and the SEC staff report, the SEC followed a very deliberate and thorough process.

5 *See Goldstein v. SEC*.

6 Specifically, Chairman Cox indicated that regulation should not interfere with trading strategies or operations, the ability of a manager to keep the hedge fund's methods and portfolio composition confidential or the use of performance fees.

7 Based on the Chairman's prepared testimony, it seems likely that the revised standard may more closely match the "qualified client" standard applicable to the assessment of performance fees under the Advisers Act and could exclude the investor's primary residence. *See* the Managed Funds Association's *White Paper on Increasing Financial Eligibility Standards for Investors in Hedge Funds* (July 7, 2003), suggesting that the "accredited investor"

Furthermore, the Chairman intends to recommend that the SEC promulgate 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." He also told the Committee that he was directing the SEC to take emergency action to reinstate rules which were adopted alongside the hedge fund adviser registration rules but which were not specifically considered by the court in its decision.

Practical Implications for Hedge Fund Managers

Hedge fund managers who registered with the SEC solely because of the rule should consider waiting to de-register.

The ruling is stayed pending possible appeals by the SEC, so strictly speaking it is still in effect. As a result, advisers who have already registered should probably wait to de-register until it is either officially announced that the SEC will not seek to have the case reversed, or an appeals route is clarified. For example, if the SEC seeks Supreme Court review, the Circuit Court opinion may or may not be stayed until a decision is made by the Supreme Court whether or not to hear the case. As noted above, the SEC could appeal and, as a result, the court has stayed its ruling to give the SEC time to make a decision. This stay could continue as long as the appeals process is in effect.

The rule was controversial when first adopted by a vote of three to two. Several current Commissioners were not on the Commission when it first passed the hedge fund rule, making any prediction that much harder. There is a lot of speculation about what the SEC will do, but anything is possible until the SEC makes a formal decision (which is expected no later than August 7, 2006). Additionally, intervening congressional action could have the effect of reversing the court's ruling. There are significant consequences to operating as an unregistered adviser in the face of a registration requirement, and there is uncertainty regarding the effect of violating a registration requirement that is subsequently struck down. While some managers may be willing to take the risk that the ruling will stand, given the consequences of not registering, advisers may wish to await further developments.

The status of advisers that registered under protest may be a bit unclear. Therefore, unless the court or SEC specifies an alternate procedure, if an adviser chooses to take the risk that the ruling will stand, wishes to be unregistered going forward and qualifies for an exemption, that adviser should file the Form ADV-W and officially de-register. The SEC staff has no direct way of knowing if an adviser qualifies for an exemption going forward and does not wish to be registered unless that adviser takes steps to de-register.

Most hedge fund managers who registered with the SEC solely because of the rule may remain registered if they wish, even if the rule is permanently vacated.

Advisers are not required to rely on the private adviser exemption. As long as an adviser meets the definition of investment adviser (advising others as to securities for compensation) and has $25 million in assets under management or is based outside the United States (or in a U.S. jurisdiction which does not offer state registration), that adviser may stay registered with the SEC.[8]

Because registration has consequences, including residual recordkeeping responsibilities and continuing examination authority with respect to the time during which the adviser was registered, advisers who registered solely as a result of the rule (and de-register promptly following final determination of the rule's status) may be able to argue that they should be treated by the SEC as though they were never registered. However, advisers that choose to remain registered should not be affected. Everyone should remember that some of the anti-fraud provisions of the Advisers Act apply even to unregistered advisers, and the SEC has jurisdiction over them even if the adviser is not required to register.[9] SEC jurisdiction over non-

standards of the Securities Act of 1933 be amended to increase the standards of financial eligibility for natural persons investing in pooled investment vehicles.

8 *See* Section 202(a)(11) and Section 203 of the Advisers Act.

9 Chairman Cox specifically mentioned this point in his testimony to the U.S. Senate Committee on Banking, Housing, and Urban Affairs.

U.S. advisers is expansive and generally applies to advisers with U.S. clients, among others.

Hedge fund managers who are currently registered but plan to de-register in the future may be examined by the SEC.

The staff can inspect any registered adviser, but an adviser might inform the SEC of the adviser's intent to de-register and encourage the SEC to delay its inspection (and check the latest news on the status of the ruling). The inspection staff has no way of knowing if an adviser plans to de-register unless that adviser tells them. Advisers should, however, expect the SEC to go forward with the examination. In his testimony, Chairman Cox informed the Committee that he has "directed the SEC staff to continue to conduct compliance examinations of investment advisers who remain registered with [the SEC] or register with [the SEC] in the future."

Non-U.S. hedge fund managers relying on the "lite" regime will likely continue to be able to follow the "lite" regime.

The "lite" regime lets advisers based outside of the United States avoid having to comply with many of the requirements of the Advisers Act, such as having a written compliance program and the cash solicitation rule. Since the origin of the lite regime is from no-action letters written by the SEC staff, the staff is likely to permit this type of arrangement going forward. Additionally, Chairman Cox indicated his view that the loss of the lite regime would be a disincentive to registration which should be avoided and informed the Committee that the SEC staff had been directed to address this issue.

Legal Implications of the Ruling

The rule changes adopted at the same time as the hedge fund adviser registration rule have also been vacated by the court decision, but may be re-adopted in the future.

As written, the decision seems to vacate the hedge fund adviser registration rule and everything else that was adopted at the same time, even though the reasoning of the case would not seem to apply to those rules—in effect, throwing the baby out with the bathwater. This aspect of the decision did not appear to be particularly well crafted so it is unclear whether the court intended to reverse other contemporaneous rulemaking along with the re-definition of "client." If the court's decision remains, the SEC will need to consider how it will address those rules and the related Form ADV amendments. We hope that, whatever course the SEC takes with the appeal, they will seek to clarify the fate of these rule and form amendments.

Chairman Cox stated in his testimony that he would be "directing the SEC Staff to take emergency action to ensure that the transitional and exemptive rules contained in the 2004 hedge fund rule are restored to their full legal effect." This would include the transitional and exemptive provisions of the rules, the provision governing the restrictions on performance fees for hedge fund adviser contracts that were entered into before the hedge fund rule went into effect, and the provision providing an extension of time given to advisers of funds of hedge funds to provide their audited financial statements. However, it remains to be seen what these "emergency actions" will be.

The fiduciary duties of hedge fund advisers may also have been changed by the court's decision.

The decision may be seen to alter the focus of a hedge fund adviser's fiduciary duty to some extent.[10] Previously, the SEC staff has asserted that the adviser owed certain duties to the fund's investors (even if it was not clear that those investors were "clients" as such). Thus, the SEC staff took the position that duties owed, disclosures required, and other obligations to clients related to the investors in the fund in a manner similar to separate account clients, and not just the fund itself. Although the issue of whether the SEC staff was right to take this position under the law has been debated in legal circles for some time, many thought that it was prudent to follow that view to the extent practicable to avoid unnecessary conflicts with the inspection staff.

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 under the Advisers Act, the fund, not the investor, is the client.[11] Thus, for purposes of the Advisers Act, the ad-

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10 *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) (holding that Section 206 of the Advisers Act created a fiduciary duty of loyalty between an adviser and his or her client).

11 *See Goldstein v. SEC* ("[T]he Commission's interpretation of the word "client" comes close to violating the plain language of the statute. At best it is counterintuitive to characterize the investors in a hedge fund as the "cli-

viser owes its fiduciary duties to the fund, not any particular investor(s).

While the decision does not necessarily settle the issue, at the very least 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 possible fiduciary duties to the investors in the fund such as ERISA and state law. Also, advisers should continue to monitor the actions of the SEC. 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 rulemaking 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."

Interested persons are strongly encouraged to follow developments in the case over the coming weeks.

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ents" of the adviser. . . . The adviser owes fiduciary duties only to the fund, not to the fund's investors").

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