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The US hedge fund adviser registration rule has been thrown out by a court

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The Court of Appeals for the District of Columbia has vacated the 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 US Investment Advisers Act.

Any investment adviser that has had fewer than 15 "clients" in the last 12 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.

For non-US advisers, only US 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 Act.

In vacating the rules, the court did not analyze the policy concerns behind the rule change. Rather, the court held that the SEC had exceeded its authority to promulgate interpretive rules under the 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 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 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."

Although the court vacated the rules (including other rules passed contemporaneously with the look-through rule but 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 yet given any indication as to whether it intends to appeal the court's decision or reintroduce rules which might have the same effect but would deal with the issues identified by the court.

Additionally, 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. Additionally, 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.

This article looks at some of implications of the ruling.

1. The court struck down the rule. Any legal reason I should not de-register today?

The ruling is stayed pending possible appeals by the SEC so it is, strictly speaking, 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). 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.

2. If the rule does go away, I no longer have to be registered but for business reasons I want to stay registered (perhaps better said, my investors want me to stay registered). Can I stay registered and do I have to do anything to make sure the court ruling does not automatically revoke my registration?

Advisers are not required to rely on the private adviser exemption. As long as you meet the definition of investment adviser (advising others as to securities for compensation) and have $25 million in assets under management or are based outside the United States (or in a US jurisdiction which does not offer state registration), you may stay registered with the SEC. 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 Act apply even to unregistered advisers and the SEC has jurisdiction over them even if the adviser is not required to register. SEC jurisdiction over non-US advisers is expansive and generally applies to advisers with US clients, among others.

3. I am glad the rule is gone and never wanted to be registered. Do I have to do anything?

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

4. What if I plan to de-register if the rule goes away but the SEC staff wants to inspect me now?

The staff can inspect any registered adviser, but you might inform them of your intent and encourage them to delay your inspection (and check the latest news on the status of

the ruling). The inspection staff has no way of knowing if you plan to de-register unless you tell them. You should, however, expect them to go forward with the examination.

5. If the SEC determines to protest the court's determination, what will happen?

The SEC can seek re-hearing 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 re-hearing 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.

6. I am a non-U.S. adviser relying on the "lite" regime. Even if the rule goes away, I would prefer to remain registered as long as I can still follow the lite regime. Can I?

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. Hopefully the staff will make an announcement, in some form, that they will accept this practice going forward.

7. The SEC adopted several changes along with the re-definition of "client" such as extending the deadline for the financial statements for funds of funds. What about those?

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. Hopefully, if the decision stands, the SEC will readopt in some form those provisions not related to the re-definition of "client" or dependent upon the challenged aspects of the rule. 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.

8. Does the case change anything else?

Yes, the decision may be seen to alter the focus of a hedge fund adviser's fiduciary duty to some extent. 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 Act, the fund,not the investor, is the client. Thus, for purposes of the Act, the adviser 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 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.

9. Can you explain to me in plain English why the court struck down the Rule?

Most of the court decisions governing rulemaking by administrative agencies look at the process by which the rule was made, such as whether there was sufficient notice of the proposed rule, whether the comment period was long enough and the like. 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.

Rather in this case, the court struck down the rule on substance – that the SEC's reinterpretation of the term "client" was arbitrary and unreasonable and, therefore, overstepped the SEC's (generally broad) rulemaking authority.

Since the decision is based on an interpretation of the statute, Congress could change the result by changing the statute, and legislation to do so has been introduced. The chances that such legislation will pass in the near term appear slim, but in the longer term it is more difficult to predict. However, the court's decision puts the ball squarely in Congress's court to decide whether the SEC should have the authority to interpret "client" as it did under the vacated rule or for Congress to step in and define the term as Congress sees fit. Additionally, the SEC could, in theory, attempt to regulate hedge funds or their managers under existing authority through alternate means.

Interested persons are strongly encouraged to follow developments in the case over the coming weeks. Mr. Vaughan may be contacted at +1.202.261.3355 or david.vaughan@dechert.com and Mr. Sherman may be contacted at +1.202.261.3449 or michael.sherman@dechert.com.

This article is intended for general interest only and is not legal advice on which anyone should rely. You are encouraged to seek advice specific to your situation and up-to-date with the evolving situation surrounding the hedge fund rule.

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