CAHILL GORDON & REINDEL LLP
EIGHTY PINE STREET
NEW YORK, NEW YORK 10005-1702
TELEPHONE: (212) 701-3000
FACSIMILE: (212) 269-5420

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SEC Hedge Fund Rule Vacated in *Goldstein* v. *SEC*

On June 23, 2006, the Court of Appeals for the District of Columbia unanimously held in *Goldstein* v. *SEC*[1] that a 2004 SEC rule[2] which requires advisers of hedge funds with fifteen or more investors to register with the SEC ("Hedge Fund Rule") is arbitrary and unreasonable.

I. BACKGROUND

In late 1998, Long-Term Capital Management, a Connecticut based hedge fund which managed more than $125 billion in assets at its peak ("Long-Term"), almost collapsed.[3] The collapse threatened all of the nation's major financial institutions. The president of the Federal Reserve Bank of New York personally intervened and engineered a bailout of the fund to "avoid a national financial crisis."[4]

With the growth of the hedge fund industry despite LongTerm's failure, the SEC came to believe that it was necessary and appropriate to extend its regulatory oversight to the entities that managed hedge funds. As a result, the SEC proposed and then adopted the Hedge Fund Rule by a three to two vote of the SEC Commissioners then in office.[5] The SEC justified the Hedge Fund Rule by citing three recent developments in the hedge fund industry: (1) hedge fund assets grew by 260 percent from 1999 to 2004, despite Long-Term's failure;[6] (2) a trend toward "retailization" of the industry, including investment in hedge funds by charitable organizations and the development of "funds of hedge funds" that offered

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1 No. 04-1434, slip op. (D.C. Cir. June 23, 2006).

2 Investment Advisers Act Rule 203((b)(3)-2 and related amendments to Rule 203(b)(3)-1.

3 *Goldstein*, No. 04-1434, slip op. at 6.

4 *Id*. citing ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2004).

5 *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Release No. IA-2333 (Dec. 10, 2004) available at http://www.sec.gov/rules/final/ia-2333.htm

6 *Id*. at 6-7, citing Hedge Fund Rule, 69 Fed. Reg. at 72,055.

shares to the public, which exposed more ordinary investors to the risks of hedge funds;[7] and (3) the increase in the number of fraud actions brought against hedge funds.[8]

The Hedge Fund Rule requires advisers of hedge funds with fifteen or more investors to register with the SEC.[9] Hedge fund advisers had been exempt from SEC regulation under the Investment Advisers Act of 1940 ("Advisers Act"), which offers a "private adviser exemption" for "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients . . . ."[10] The SEC had interpreted "clients" to refer to the funds themselves, but the Hedge Fund Rule states that "clients" includes "the shareholders, limited partners, members, or beneficiaries . . . of [the] fund."[11]

Philip Goldstein, Kimball & Winthrop (an investment firm Goldstein owns), and Opportunity Partners L.P. (a hedge fund in which Kimball & Winthrop is the general partner and investment adviser) brought suit to challenge the Hedge Fund Rule's equation of "client" and "investor."[12]

II. RATIONALE OF THE COURT (PER RANDOLPH, J.)

The court first argued that the text of the Advisers Act ruled out the SEC's interpretation of the term "clients." It did so in dicta, conceding that a 1980 amendment to the Advisers Act, which states that investors may be deemed clients of an investment adviser if they are clients of the adviser "separate and apart" from their status as investors, made the definition of "clients" less clear.[13]

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7 *Id*. at 7, citing Hedge Fund Rule, 69 Fed. Reg. at 72,057-58.

8 *Id.*, citing Hedge Fund Rule, 69 Fed. Reg. at 72,056-57.

9 *Id*. The court also noted that application of the new rule triggers regulations that apply only to registered advisers, who "must open their records to the SEC upon request, 15 U.S.C. § 80b-4, and cannot charge their clients a performance fee unless such clients have a net worth of at least $1.5 million or at least $750,000 under management with the adviser. *Id*. § 80b-5 . . . ." *Id*. at 6-7.

10 *Id*. at 5-6, quoting Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq*., § 80b-3(b)(3) ("Advisers Act").

11 *Id*. at 7, quoting Hedge Fund Rule, 17 C.F.R. § 275.203(b)(3)-2(a).

12 *Id*. at 2.

13 *Id*. at 9, citing Advisers Act, 15 U.S.C. § 203(b)(3). The court noted that this was a weak argument since, in promulgating the 1985 safe harbor rule, *see infra* note 18 and accompanying text, the SEC stated that it was "incorporat[ing] the approach of the 1980 Amendments into a limited partnership rule" to give "greater certainty" to the term "clients." *Id*. at 11, quoting Definition of "Client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 Fed. Reg. 8740, 8740-41 (Mar. 5, 1985).

A 1970 amendment to the Advisers Act "explicitly made the fewer-than-fifteen-clients exemption unavailable to [advisers who advise only investment companies]".[14] The court reasoned that such a "prohibition would have been unnecessary if the shareholders of investment companies could be counted as 'clients.'"[15] Such companies are unlikely to have so few shareholders. If shareholders count as "clients," then the exemption would be meaningless for such advisers and not worth revoking.

The court also noted that, though the Advisers Act does not define "clients," it defines "investment adviser" as someone who "directly" advises others.[16] Hedge fund advisers do not directly advise hedge fund investors, but rather manage the fund's investments. The investors in hedge funds are passive, having no role in the management or governance of the hedge funds. The court reasoned that if the person or entity controlling the fund is not an adviser to individual investors, then individual investors cannot be clients of such advisers.[17]

The court noted that the SEC, in 1997, explained that hedge fund advisers must consider the needs of the fund and have "no obligation to ensure that each security purchased for the company's portfolio is an appropriate investment for each shareholder."[18] The SEC also promulgated a safe harbor rule in 1985, concerning investment companies organized as limited partnerships. Under the safe harbor rule, the client — for purposes of the fifteen client exemption — is the limited partnership itself.[19]

The court then held that the Hedge Fund Rule was unreasonable, even if it did not contradict the text of the Advisers Act. The Supreme Court has held that the Advisers Act "created a fiduciary duty of loyalty between an adviser and his client."[20] If advisers owe fiduciary duties to both the fund and its investors, "then the adviser will inevitably face conflicts of interest."[21] For example, if a fund was about

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14 *Id*. at 11, citing Investment Company Amendments Act of 1970, Pub.L.No. 91-547, § 24, 84 Stat. 1413, 1430 (1970).

15 *Id*.

16 *Id*., quoting Advisers Act, 15 U.S.C. § 80b-2(11).

17 *Id*. at 11-12.

18 *Id*. at 12, quoting Status of Investment Advisory Programs Under the Investment Company Act of 1940, 62 Fed. Reg. 15,098, 15,102 (Mar. 31, 1997).

19 *Id*., citing 17 C.F.R. § 275.203(b)(3)-1(a)(2).

20 *Id*. at 14, citing *SEC* v. *Capital Gains Research Bureau, Inc*., 375 U.S. 180, 191-92 (1963).

21 *Id*. at 15.

to go bankrupt, the adviser would have to advise the fund to do anything it could to remain solvent, while also advising the investor to sell his interest.[22]

The court stated that the SEC did not justify its claim that "clients" should include investors. First, the court saw no reason for the term "clients" to have one meaning in terms of fiduciary duties and another in terms of which investment advisers must register with the SEC.[23] Second, the SEC did not cite any characteristics of the investor-adviser relationship that would justify registration requirements.[24] Third, the SEC's argument contradicts its prior interpretation of "clients." The court stated that the Hedge Fund Rule acts as a carve-out from the SEC's safe harbor rule — which has been extended to include corporations, limited liability companies, and business trusts — "solely for investment entities that have fewer than one hundred-one [sic] but more than fourteen investors."[25]

Finally, the court stated that the Hedge Fund Rule bears no rational relationship to Congress' policy goals in passing the Advisers Act. Congress sought to regulate financial entities with a large scope, but the number of investors "reveals nothing about the scale or scope of the fund's activities."[26] The Hedge Fund Rule leads to the illogical situation where "funds with one hundred or fewer investors are exempt from the more demanding Investment Company Act, but those with fifteen or more investors trigger registration under the Advisers Act."[27] The court held that the SEC's "manipulation of meaning" was arbitrary.[28]

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22 *Id*. This reasoning also prevents courts from ordinarily considering the shareholders of a corporation to be the clients of the corporation's counsel. *Id.*

23 *Id*. at 16.

24 *Id*. at 17. The court suggested that, even if the SEC could show that different classes of investors had different relationships with investment advisers, this could not justify "treating *all* investors in hedge funds as clients for purposes of the rule (emphasis in original)." *Id*. If some investor-client relationships bear the marks of "client" relationships, then the SEC "should have identified those characteristics and tailored its rule accordingly." *Id.*

25 *Id*. at 18. The Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, requires any issuer of securities "that is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities." to register with the SEC and thus become subject to SEC oversight. Many hedge funds are statutorily exempted from this requirement because they have one hundred or less beneficial owners and do not offer their securities to the public. *See id*. at 3, quoting 15 U.S.C. § 80a-3(a)(1)(A), 80a-3(c)(1).

26 *Id*. at 19.

27 *Id*.

28 *Id*. at 16.

III. SIGNIFICANCE OF DECISION

The holding in *Goldstein* means that advisers of hedge funds with fifteen or more investors no longer need to register with the SEC. Regulations that stem from this reporting requirement also no longer apply to such advisers and their hedge funds.

The court pointed to an appealable issue, suggesting that the SEC may be able to show that some investors are "clients" based on the characteristics of the investor-adviser relationship.[29] However, SEC chairman Christopher Cox has yet to state whether the SEC will appeal the court's decision.[30]

The court's comments also suggest that a more narrowly tailored rule, with more specific findings of fact, may pass judicial scrutiny.[31] Mr. Cox has stated that the *Goldstein* ruling requires the SEC to "re-evaluate [its] approach to hedge fund activity" and is "a spur to improvement in . . . our rule making process and the effectiveness of our programs to protect investors, maintain fair and orderly markets, and promote capital formation."[32]

Though hedge fund advisers may now choose to de-register, some predict that many advisers may choose not to do so. Institutional investors have been increasingly investing in hedge funds, and such investors tend to prefer funds having advisers that are registered with the SEC.[33]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; or John Schuster at (212) 701-3323 or jschuster@cahill.com.

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29 *See supra* note 23 and accompanying text.

30 Floyd Norris, *Court Says S.E.C. Lacks Authority on Hedge Funds*, N.Y. TIMES, June 24, 2006, at A1 (hereinafter "*S.E.C. Lacks Authority*"); Kara Scannell et al., *SEC Dealt Setback as Court Rejects Hedge-Fund Rule*, WALL ST. J., June 24, 2006, at A1.

31 *See supra* note 23 and accompanying text.

32 *S.E.C. Lacks Authority* at A1.

33 *See id*. at A9.