Federal Court Invalidates SEC Hedge Fund Manager Registration Rule

On June 23, 2006, the United States Court of Appeals for the District of Columbia Circuit ruled in the case of *Phillip Goldstein, et al*. v. *Securities and Exchange Commission* that the Securities and Exchange Commission ("SEC") exceeded its authority when it adopted Rule 203(b)(3)-2 ("Rule") under the Investment Advisers Act of 1940 ("Act") which requires managers of hedge funds with more than $25,000,000 in assets and fifteen or more investors to register as investment advisers with the SEC. The court vacated the rule and sent it back to the SEC for reconsideration. The Rule had defined the word "client" under Section 203(b) of the Act to include a "look through" provision that counted each investor in each fund as a client when determining a manager's eligibility for the exemption from registration under the Act for advisers with fewer than fifteen clients. Advisers who previously claimed the exemption were obligated to register with the SEC by February 1, 2006 unless they qualified for continued exemption under a grandfather provision for funds that did not accept any new investors or if the fund could be excluded from the Rule's definition of a "private fund" by virtue of a lockup of investor funds for at least two years. In order to avoid registration, many funds ceased accepting new investors and others imposed two-year lockup periods. However, the Rule caused approximately 1,000 managers who were previously exempt to register as investment advisers with the SEC.

In its opinion deciding the case brought by hedge fund manager Philip Goldstein, the Court of Appeals stated that hedge funds are notoriously difficult to define and that the SEC's interpretation of the word "client" was inconsistent with existing interpretations and comes close to violating the plain language of the law. The court also noted that the volume of assets under management or the extent of indebtedness of a hedge fund or other such financial metrics determines a fund's importance to national markets and not the number of clients. As a result, the court opined that the SEC's rule was vague and "arbitrary."

The case is highly significant not only for its repudiation of the SEC's rulemaking authority but also because most hedge fund managers will now not be subject to SEC registration requirements. Although the Act's antifraud, anti-manipulation and insider trading rules continue to be applicable to investment advisers to hedge funds, the significant costs of the registration, compliance and inspection regimes that are applicable to SEC-registered investment advisers are now inapplicable to the great majority of unregistered hedge fund managers. Managers will be able to count each fund as a single client and thus will more easily be able to avoid SEC registration by keeping the number of their clients below fifteen. Funds that have adopted two-year lockups in order to escape classification as a "private fund" subject to the Rule will now be able to amend their governing documents to remove those restrictions. Funds that stopped accepting new investors in order to be grandfathered under the prior definition of "client" will again be able to accept new investors. The court's ruling does not, however, nullify existing registrations. If a fund manager has registered as an investment adviser with the SEC, that registration will continue in effect unless the fund manager takes action to deregister.

SEC Chairman Christopher Cox issued a press release in response to the court's adverse decision saying that the SEC would review the ruling and consider alternatives. Given the state of the current debate regarding hedge funds, it seems that it will be difficult for the SEC to take significant further action to regulate hedge funds in the near future. The Rule had engendered significant criticism when proposed from many influential organizations and persons, including ex-Federal Reserve Board Chairman Alan Greenspan, to the effect that registration is unnecessary and inappropriate for funds which are limited by law to obtaining investments only from wealthy and sophisticated investors. Moreover, the court's ruling significantly circumscribes the SEC's ability to regulate by redefining terms that are in the Act and withe accepted meanings for many years. In the absence of any major new hedge fund scandals or revelations, the court's ruling will provide further support for critics of the Rule and is likely to discourage Congress from acting upon any SEC request for further regulatory authority over hedge funds. Nevertheless, fund managers should recognize that the Congress may act based on concerns about some hedge fund practices like short selling and based on the encouragement of state regulators. Moreover, the SEC may be able to find a way to produce some form of regulation which could result in a reimposition of the registration requirement or in imposition of many if not all of the rules applicable to registered investment advisers.

In the absence of further SEC action, fund managers should also stay alert to the possibility of new state regulation initiatives. In testimony before the Senate Judiciary Committee on June 28, 2006, Connecticut Attorney General Richard Blumenthal said that, in the wake the Goldstein decision, the $24 trillion hedge fund industry is a "regulatory black hole," adding that states must consider filling the void if Congress fails to take further action to regulate hedge funds.

If you would like more information about the foregoing or about the regulation of investment advisers generally, please feel free to contact Robert A. Hudson directly at 313 225 7019, or hudson@butzel.com or Jennifer Powell at 248 593 3023, or powell@butzel.com.

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