FEDERAL COURT INVALIDATES HEDGE FUND REGULATION

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In a stunning set back to the SEC, the Federal Appeals Court in the District of Columbia recently struck down and invalidated the SEC's 2004 Rule adopted to boost the agency's oversight of hedge funds. The rule, adopted in December, 2004 which took effect February 1, 2006 and which caused an uproar throughout the hedge fund industry due to the reporting and disclosure requirements it imposed, was an amendment to the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1, *et seq.,* known as Registration Under the Advisors Act of 1940 (the "Act"). While many hedge fund managers, who operate with a great deal of privacy and autonomy from governmental examination and investigation, applaud the decision and are glad to be able to continue to operate in privacy, the Court struck down the SEC rule after most hedge funds went to the great expense, time and effort of attempting to either comply with or figure out how to avoid complying with the Act. The Act required any hedge fund managing more than $25 million to register with the SEC as an Investment Advisor, provide extensive details about its operations and submit to periodic SEC audits and supervision.

At least for now, and until the SEC can figure out how to exert the supervision and control of the exploding number of hedge funds, hedge fund managers who already complied with the Act face a dilemma. Do they continue to report as Investment Advisers assuming the SEC, which is hell bent on regulating them, ultimately will adopt a rule that passes judicial scrutiny or do they file a form ADV-W and effectively withdraw their hedge funds as Registered Investment Advisors?

<u>What Is A Hedge Fund</u>

Currently, there are approximately 8,000 investment vehicles that generically fall into the vague definition of "hedge funds" and collectively, they have approximately $1 trillion under management. These hedge funds currently account for one-fifth of all U.S. stock trading volume. There is, however, no hard and fast definition of what is a hedge fund. The term does not appear anywhere in the federal securities laws and even the industry cannot agree on a single definition.

Hedge funds typically are investment partnerships (typically formed as limited partnerships of limited liability companies) which pool money from wealthy individuals (referred to as "accredited investors") and institutional investors, including pension funds, insurance companies and other entities interested in pursuing sophisticated and potentially risky investment strategies with the hope of realizing outsized, above market returns. Hedge funds, generally speaking, are entities that hold a pool of securities and other assets, whose interests are not sold in a registered public offering and which historically were not registered as an investment company under the Investment Advisors Act of 1940. The reference to "hedge" in hedge funds is purely a misnomer. Some hedge funds actually employ hedging techniques; many don't. The investments strategies vary greatly and most hedge fund managers prefer their anonymity and attempt to avoid scrutiny to protect their various proprietary investment and trading strategies.

By contrast, the bulk of *registered* investment companies are mutual funds, which currently have approximately $8 trillion under management. The differences between registered and regulated mutual funds and unregistered and unregulated hedge funds are substantial. Whereas federal regulations prohibit mutual funds from, for example, trading on margin or engaging in short sales, these strategies sometimes are at the core of the typical hedge fund transactions. Hedge funds trade and invest in all kinds of assets, including traditional stocks, bonds, and currencies to the more esoteric financial derivatives and non-financial assets. Most hedge funds often use leverage to increase their potential returns (and their risk as well). Mutual funds typically buy, sell and hold traditional stocks, bonds or a mixture without leverage, margin or short selling.

Unlike mutual funds, which must comply with complicated and expensive detailed reporting requirements for independent boards of directors and whose shareholders must specifically approve of certain changes and actions, hedge funds operate outside of SEC regulation and need not, now that the Act has been struck down, make any disclosures; need not obtain investor approval of various actions and have great freedom to operate as they please with virtual autonomy for the hedge fund manager. Most hedge funds are formed as limited partnerships with the general partner (typically another entity, either a limited liability company, corporation or another limited partnership) manage the business of the hedge fund for a fee. The most often referred to fee structure is the "2% and 20%". That is, the manager is paid 2% of the hedge fund's asset value, regardless of performance or return, and 20% of the profits, if any. Since the typical hedge fund has over $1 billion under management, the 2% fee, earned regardless of performance or profit, alone can bring the manager a guaranteed $20 million per year. Quite attractive and one of the principal reasons everyone with any trading experience wants to form a hedge fund.

<u>Philips Goldstein, et al v. SEC</u>

Philip Goldstein, who owns an investment advisory firm, and the hedge fund that it managed brought the case that, invalidated the reporting requirements for hedge funds. The plaintiffs in the case argued that the SEC had exceeded its authority in re-interpreting the Investment Advisor Act of 1940. Before the Act was adopted by the SEC in late 2004, hedge funds relied on the "private adviser exemption" which exempted from registration as an Investment Advisor "any investment adviser who, during the previous twelve months "has had ***fewer than fifteen clients*** and neither holds himself out generally to the public as an investment advisor nor acts as an investment adviser to any investment company registered under the Investment Company Act." As discussed below, it is the definition of "client" that is at the heart of the Appeals Court's decision.

Most will remember what is probably the most infamous of all hedge funds, Long-Term Capital Management, based in Greenwich, Connecticut that had more than $125 billion in assets under management at its peak. In late 1998, that fund nearly collapsed putting at risk almost all of the country's major financial institutions due to their credit exposure to Long-Term Capital. The problem was so severe, that the President of the Federal Reserve Bank of New York was forced to personally intervene to engineer a bailout of the fund to avoid a national financial crisis. As a direct result of the

Long-Term Capital Management fiasco, the SEC began working on a rule that would subject hedge funds to scrutiny and registration. The Act was the result, passed 3-2 by the SEC Commissioners in late 2004. The Act, by its terms, took effect as of February 1, 2006.

In striking down the Act, the Appeals Court focused on the definition of "client". The SEC and earlier case law, defined "client" as the actual entity being advised, not the shareholders or limited partners holding interests in the entity. The Court held that the SEC could not justify its changed definition that "client" meant not the entity that the manager was advising but the total of the number of investors in that entity. The Investment Adviser Act precluded government regulation under the more demanding provisions of the Investment Company Act of investment companies with fewer than 100 investors, while the SEC, in adopting the Act, determined that investment companies with fifteen or more "investors" would trigger registration under the Investment Advisers Act. The Court ultimately determined that the SEC's rule was "arbitrary" and invalidated it.

<u>The Dilemma Faced By Hedge Funds</u>

While not happy about the Act when it was adopted in late 2004, virtually all U.S. based hedge fund managers began the time-consuming, expensive and complicated process of registering their funds under the Investment Advisor Act. The cost of compliance for the typical hedge fund ran into the hundreds of thousands of dollars for legal, accounting and compliance work. Now that a Federal Appeals Court has invalidated the Act, the question most fund managers' face is whether to continue to voluntarily file and report as registered Investment Advisors or file a form ADV-W and withdraw from registration.

While most managers will, and many already have filed form ADV-W's and quickly removed themselves from voluntary compliance, allowing them to continue to pursue their various trading and investing strategies in private and keep the identity of their investors, the returns and fees earned and generated away from prying eyes of the government and competing fund managers, there is a strong argument for continuing to comply and voluntarily report and file as a RIA. It is obvious that the size and number of hedge funds will continue for the foreseeable future. The combination of the potential financial rewards to investors and, more importantly, to the fund managers, and the amount of investment capital searching for higher yields, virtually guarantee the continued growth of the hedge fund world.

At the same time, more and more of these funds are taking in money from what might be considered "retail" clients. High net worth individuals to be sure but investors who might not be a sophisticated at evaluating risk as institutional investors. The SEC, in turn, will continue to focus on its stated goal of protecting the investing public. Although it struck down the Act as "arbitrary", the Federal Court did remand the case with a directive to the SEC to draft and adopt a rule that would pass judicial muster. The SEC recently announced that it would not appeal the *Goldstein* decision, but SEC Chairman Cox is pushing for emergency regulations on hedge funds and the SEC is unlikely to move its focus from hedge funds and high-risk, high-reward investment pools until the industry is under some form of regulation and public filing requirement.

As hedge funds continue to proliferate, and as more of them fail, as some undoubtedly will, it is only a question of time when the SEC will come up with a new rule that passes judicial scrutiny. At that point, those funds that have voluntarily complied with registration under the Investor Adviser Act, and which have the experience and history of compliance under control, will be in the best position to transition to the new rule, whatever it is and whenever it is adopted.\

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