

Hedge Fund Madness

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Once again hedge funds—a.k.a. financial lightning in a bottle—have defied efforts by regulators to monitor their activities. With more than \$2 trillion invested in the world's capital markets, hedge funds are the sine qua non of black box securities: intentionally speculative and accessible only to wealthy individuals and institutional investors. And the hedge fund advisers like it that way.

In late June, barely four months after a new SEC rule took effect requiring the registration of hedge fund advisers, the U.S. Court of Appeals for the D.C. Circuit vacated the rule and remanded it to the SEC. The challenge was brought by a single hedge fund adviser, Phillip Goldstein of Opportunity Partners LP in Pleasantville, New York, who called registration "a power grab" earlier this year in a *Wall Street Journal* profile. "The SEC is not elected and not accountable to the people, and yet it is making laws," Goldstein said.

The D.C. Circuit agreed, focusing narrowly on the SEC's rereading of the so-called look-through provisions of its new rule (section 203(b)(3) of the Investment Advisers Act of 1940). Taking the SEC to task for redefining the word "client" to mean each investor rather than each fund managed by an adviser, the court stated, "the 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 'clients' of the adviser." (*Goldstein v. Sec. and Exch. Comm'n*, 2006 U.S. App. LEXIS 15760.)

Hedge fund registration first became an issue after the release of an SEC staff report in September 2003. The commission had justified registration for three by 260 percent from 1999 to 2004; a trend toward "retailization" of hybrid funds that increased the exposure of ordinary investors; and a series of well-publicized fraud actions brought against individual funds. Despite heated opposition from hedge funds and their representatives, former SEC Chairman William H. Donaldson pushed through the rule on a 3–2 vote in October 2004. (69 Fed. Reg. at 72, 055–58.)

"Donaldson jammed this rule through, despite the extraordinary opposition of the other two Republicans on the commission," says Douglas L. Hammer, a partner in the hedge fund practice at Shartsis Friese in San Francisco. "It was a political statement that the SEC was actually doing something about hedge funds. Now the key guy is Cox."

Indeed, current SEC Chairman Christopher Cox issued a statement immediately after the D.C. Court's decision was released. "I have instructed the SEC's professional staff to promptly evaluate the court's decision, and to provide to the Commission a set of alternatives for our consideration," Cox stated.

But many funds had already registered when the Hedge Fund Rule took effect February 1, and others did so last year in anticipation of the SEC's action. So now what? The dilemma brings to mind an old *New Yorker* cartoon, published just after the Vatican II reforms, that shows an assistant asking the Devil, "What should we do with all the Catholics who ate meat on Friday?"

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