



FULL DISCLOSURE BY THOMAS BROM

Hedge Fund Madness

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

reasons: the growth of hedge fund assets 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, pub-

lished 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?”

Registration can be a significant burden. Requirements include appointing a chief compliance officer and accepting periodic visits from the SEC's Office of Compliance Inspections and Examinations for a records review and an evaluation of systems and internal controls. Hammer says those examinations “can prove quite a distraction,” taking three days to three weeks, depending on the size of the hedge fund.

“I have a client who is being examined as we speak,” he says. “Now, the client could withdraw its registration—the paperwork could be done in a day, and the SEC examiner would probably lose interest. But no one knows how this is going to come out. The government could appeal the ruling in *Goldstein*, or the SEC could respond with another proposed rule. My advice is, ‘Don't do anything precipitous.’”

Mark D. Whatley, director of the Business Department at Howard Rice Nemerovski Canady Falk & Rabkin, says most of his clients had decided to register. “It's just blocking and tackling, just additional documents,” Whatley says. “But it does increase the cost of doing business.”

Adds Jay B. Gould, a partner in the Corporate & Securities group at Pillsbury Winthrop Shaw Pittman in San Francisco, “I'm not sure the court's decision changes much. Registration has become the market standard, something you could point to in due diligence. At the end of Cox's review, we'll probably

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see the SEC come back and fully justify its position.”

Not every hedge fund, however, has accepted SEC oversight. According to Whatley, many of the larger funds avoided registration this year by stepping through one of several loopholes: amending their limited partnership agreements to require a two-year lockup of new funds, or relocating offshore and throwing out all of their U.S. investors.


Registration is particularly hard to swallow in an industry dedicated to laissez-faire. During a Senate hearing in May on the “Role of Hedge Funds in our Capital Markets,” for example, hedge fund defender Senator Mike Crapo

(R-Idaho) said he hoped the court would “invalidate the rule because the SEC lacks statutory authority to require [its] provisions.”

The SEC’s statutory authority wasn’t addressed by the D.C. Circuit in *Goldstein*. “The court is not going to decide a broader question that it doesn’t have to address,” Whatley says. But by simply arguing the point, plaintiff Goldstein and his supporters showed how seriously the hedge fund industry regards unfettered speculation.

Immediately following the court’s action, Senate Judiciary Committee Chairman Arlen Specter (R-Penn.) held hearings focused on alleged fraud in the industry. But Whatley says,

“The hedge fund world is really quite clean. Fund managers take their responsibilities to investors very seriously. They’re smart people, people of good faith.”

In case the SEC and Congress eventually back off on registration, hedge fund investors who encounter problems with adviser conflicts of interest or insider trading can always sue. In January, National Union Fire Insurance Co. of Pittsburgh, a member of AIG Inc., unveiled Hedge Fund Protector, an insurance policy designed to protect hedge fund managers, directors, and officers against liability exposure and potential litigation. 

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