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CLIENT ADVISORY

SEC Chairman Cox Announces New Proposals for Hedge Fund Regulation

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On July 25, 2006, SEC Chairman Christopher Cox testified before the U.S. Senate Committee on Banking, Housing, and Urban Affairs regarding the regulation of hedge funds. The Committee called the hearing in response to the recent decision by the U.S. Court of Appeals for the D.C. Circuit in *Goldstein v. SEC*, striking down the SEC's hedge fund adviser registration rule.

Chairman Cox commented generally on developments in the hedge fund industry and then announced a number of regulatory actions the SEC may consider in light of the *Goldstein* decision. He also left the door open for legislation, which he said was the "prerogative" of Congress.

CURRENT SEC REGULATION AND ENFORCEMENT

Chairman Cox stressed that hedge funds continue to remain subject to SEC regulation and enforcement under the antifraud, civil liability and other provisions of the federal securities laws. Using this authority, the SEC has brought dozens of enforcement cases against hedge fund managers who have engaged in fraud or have violated their fiduciary obligations.

PROPOSED MEASURES

Although the SEC's ability to bring enforcement actions against hedge funds and fund managers has remained intact following *Goldstein*, the same cannot be said for the SEC's ability to require hedge fund managers to register as investment advisers and submit to SEC inspections. Chairman Cox observed that, when the hedge fund rule was adopted in 2004, the SEC stated that its then-current program of hedge fund regulation was inadequate. He said he believes "that is once again the case," and the SEC must "move quickly to address the hole that the *Goldstein* decision has left." He said some improvements are possible through administrative action; others may require legislation, although the SEC has not completed its evaluation and therefore is not proposing legislation at this time.

Chairman Cox cautioned that actions in this area should be non-intrusive and should not interfere with the investment strategies or operations, creativity, liquidity or flexibility of hedge funds. Hedge funds should not be subject to portfolio disclosure provisions which would limit the funds' ability to keep their trading confidential, and they should continue to be able to charge performance fees.

Proposed New Anti-Fraud Rule

The first action Chairman Cox will recommend is promulgation of a new anti-fraud rule under the Investment Advisers Act that would have the effect of "looking through" a hedge fund to its investors. He said this will reverse the side effect of *Goldstein* that the anti-fraud provisions of Sections 206(1) and 206(2) of the Investment Advisers Act, apply only to "clients" as the court interpreted the term—not to investors in a hedge fund.[1] He said the SEC has authority to adopt such a rule under Section 206(4), which the court in *Goldstein* acknowledged is not limited to fraud against "clients." The SEC staff currently is analyzing what the contours of such a rule might be.

Transitional and Exemptive Rules

Chairman Cox also is directing the SEC staff to take emergency action to insure that the transitional and exemptive rules contained in the now-invalidated rule are restored to full legal effect, so that any hedge fund managers which were relying on the rule are not suddenly in violation of the SEC's regulatory requirements when the court issues its final mandate in mid-August. For example, one provision of the rule was a section that prevented a registered hedge fund manager from having to renegotiate the terms of existing advisory contracts or expelling pre-existing investors from a fund which were not "qualified clients" in order to remain in compliance with the Investment Advisers Act restrictions on performance fees.

Record-Keeping Exemption

In addition, Chairman Cox is directing emergency action to restore to newly-registered hedge fund managers their qualified exemption from the record-keeping requirement for performance data prior to registration. Without such action prior to mid-August, newly-registered hedge fund managers that remain registered, but that did not create records for periods prior to their registration, would lose the ability to use their performance track records—which would discourage hedge fund managers from voluntarily remaining registered.

Audited Financial Statements Extension

Chairman Cox also is directing emergency action to restore the extension of time that was given to registered fund-of-funds managers to provide their audited financial statements. Under such extension, managers operating funds-of-funds would have one hundred eighty (180) days to provide audited financial statements, rather than one hundred twenty (120) days.

Non-U.S. Advisers

Chairman Cox said similar action is needed to reverse the effect of *Goldstein* to undo the hedge fund adviser rule as it applied to non-U.S. advisers to offshore hedge funds. Under the rule, a non-U.S. adviser had to register as an investment adviser if its funds had more than fourteen (14) U.S. investors, but the manager would be able to treat the offshore fund as its "client" for all other purposes and thus would be subject to different treatment under the Investment Advisers Act. Because *Goldstein* has eliminated this aspect of the rule, it has created doubt as to whether registered offshore hedge fund managers will be subject to all provisions of the Investment Advisers Act with respect to the offshore hedge funds, thus creating a disincentive for offshore managers to remain voluntarily registered.

[1] Notably, the Investment Advisers Act does not provide a private right of action, other than for recovery of fees. The SEC has ample authority to bring an action for violation of the anti-fraud provisions of the Investment Advisers Act regardless of whether the adviser is exempt from registration and who comprises its "clients." It is not clear what the practical impact of the new rule envisioned by Chairman Cox would be.

Amendment to "Accredited Investor" Definition

Chairman Cox has also asked the SEC staff to analyze and report to the SEC on the possibility of amending the current definition of "accredited investor" as applied to retail investment in unregistered hedge funds. He said the current definition is out of date and inadequate to protect unsophisticated investors from the risks of investment in hedge funds. Under Regulation D, for example, one definition of "accredited investor" is "any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000." The hedge fund adviser rule would have had the effect of increasing the above suitability threshold to $1,500,000 of net worth for any hedge fund which charges a performance fee, and Chairman Cox wants to see such effect restored.

Other Actions

Beyond the emergency rulemakings and other actions outlined above, Chairman Cox has directed the SEC staff to continue to conduct compliance examinations of hedge fund managers who remain registered as investment advisers or register in the future. The SEC will also continue to conduct risk-based examinations of hedge fund managers that are registered as investment advisers.

Finally, because of his concern with the possibility of "retailization" of hedge funds, Chairman Cox intends to recommend to the full SEC that it take formal steps to further limit the marketing and availability of hedge funds to unsophisticated retail investors. Chairman Cox said that the staff is not aware of any significant numbers of truly retail investors investing directly in hedge funds, but if such a development were to occur, he would view it with alarm.

Additional Testimony

In addition to Chairman Cox, CFTC Chairman Reuben Jeffery III and Under Secretary for Domestic Finance Randal K. Quarles testified before the Committee. Chairman Jeffery testified about the participation of hedge funds in the regulated futures markets, the CFTC's surveillance methods used to monitor large traders, including many hedge funds, the CFTC's investor protection regime aimed at protecting investors from fraudulent practices in the sale of commodity pools, including hedge funds, and the CFTC's recent enforcement activities involving commodity pools and hedge funds. Under Secretary Quarles provided testimony about the role that hedge funds play in and for the financial markets and identified the benefits provided and risks posed by hedge funds (the latter including leverage, misvaluations, concentration and lags in clearance and settlement systems). He said Treasury will continue to work with the SEC and the broader President's Working Group on Financial Markets—which also includes the CFTC and the Federal Reserve—on hedge fund oversight.

We will continue to keep you advised of developments. Members of Congress have begun to introduce and draft legislation in this area, and we will follow this advisory with a discussion of those measures in the near future. If you have any questions, please contact

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