

# RECENT DEVELOPMENTS IN THE REGULATION OF HEDGE FUNDS

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Presented by:  
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*“It may be that ...the strict dichotomy between clarity and ambiguity is artificial, that what we have is a continuum, a probability of meaning.” – Goldstein v. SEC*



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# Why Should I Care About Hedge Funds?

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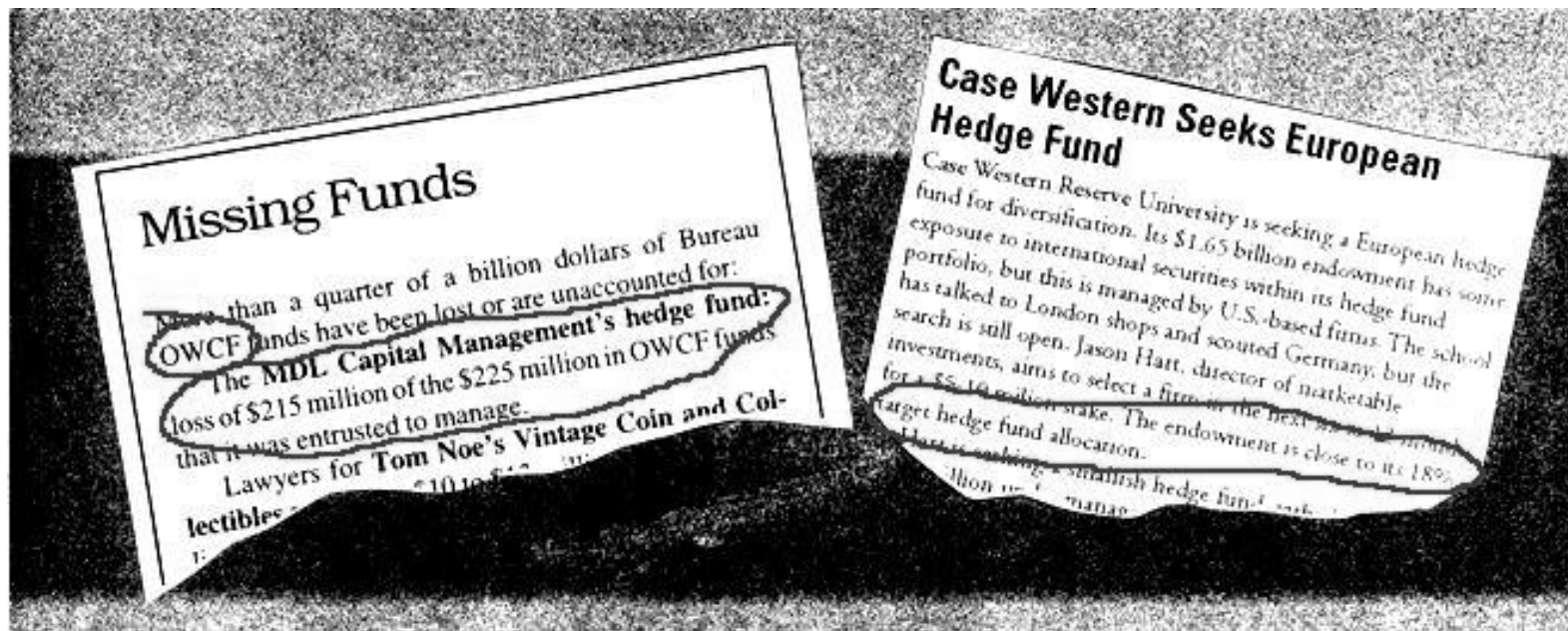
- Hedge funds are a significant factor in the securities markets
  - Worldwide, total hedge fund assets are over \$1.2 trillion
  - Compare worldwide mutual fund assets of approximately \$16.2 trillion
  - Approximately 8,000 hedge funds worldwide
    - » Source: Managed Funds Association, December 2006



# Why Should I Care About Hedge Funds?

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- Hedge funds affect many institutions, including some close to home



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# Why Should I Care About Hedge Funds?

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- Increasing numbers of individual investors and their IRAs are becoming involved in hedge funds, even locally
  - New domestic hedge fund launch in Cleveland area this month with many individual or IRA investors
  - New offshore hedge fund launch in Cleveland area this month by another sponsor



# SEC Adopts Rule Requiring Registration of Hedge Fund Advisers

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- December 2004, SEC adopts rule requiring counting of investors in “private funds” for purposes of the “fewer than 15 clients” exemption from registration under the Advisers Act
  - “Private fund” is any 3(c)(1) or 3(c)(7) fund that allows redemptions within two years after investment



# Hedge Fund Advisers Reacted

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- Many advisers registered by the February 1, 2006 deadline
- Some advisers got out of the business rather than register
- At least one adviser sued the SEC



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# D.C Circuit Rejects SEC Rule

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- June 2006, in *Phillip Goldstein v. SEC*, the Court of Appeals for the District of Columbia Circuit held that the SEC had exceeded its authority in adopting the look-through rule



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# The *Goldstein* Court's Reasoning

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- Legislative history and case law under the Advisers Act leave room for differing interpretations of the term “client”
- Case law interprets the “publishers” exemption to the effect that the relationship between adviser and client is one in which the client’s individual concerns are taken into consideration
- The count of investors in a fund is not an appropriate measure of the scale or scope of the fund in relation to the need for regulation



# *Goldstein* Does Not De-Register Advisers

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- Vacating the rule did not automatically cause hedge fund adviser registrations to be nullified
  - Registration is by application, a step separate from the rule, and there is no way to tell if an application was filed solely because of the application of the rule
  - Some advisers have de-registered, but some have not



# Section 206(1) and 206(2) Apply Only to Frauds Against “Clients”

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- Section 206 of the Advisers Act, in subsections (1) and (2) provides that it is unlawful for advisers:
  - to employ any device, scheme, or artifice to defraud **any *client* or prospective *client***; or
  - to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon **any *client* or prospective *client***



# *Goldstein* Undercuts 206(1) and 206(2) in the Hedge Fund Context

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- The *Goldstein* court found it implausible that the word “client” could mean different things in different provisions of the Advisers Act.
  - Its opinion can be read as meaning that a hedge fund investor is not a client of the adviser for **any** purpose under the Advisers Act



# Section 206(4) Is Not Limited to Clients

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- 206(4) makes it “unlawful for an adviser to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative”
  - “The Commission shall, ... define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative”



# Current 206(4) Rules Do Not Include Broad Fraud Provisions

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- The Commission has adopted six rules under section 206(4), but
  - They are narrowly focused prophylactic rules that address specific topics; and
  - They apply only to advisers registered or required to be registered with the Commission



# The SEC Proposes Broad 206(4) Rule in Pooled Investment Context

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- SEC has proposed Rule 206(4)-8, which would:
  - Make it a “fraudulent, deceptive, or manipulative act, practice or course of business” for any investment adviser (whether SEC registered or not) to a “pooled investment vehicle” to
    - Make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or
    - Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle



# Rule 206(4)-8 “Pooled Investment Vehicle” is Broad

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- “Pooled investment vehicle” is any investment company under the Investment Company Act or any fund that would be an investment company but for section 3(c)(1) or 3(c)(7) of that act
  - Includes registered funds
  - No exception based on “lock-up” period



# **Rule 206(4)-8 Not Limited to Sales or Purchases; No Scierer Required**

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- The proposed rule is not tied to the sale or purchase of an interest in a fund
  - Misleading valuations or statements of account could give rise to a violation
- According to the Commission, no showing of scierer would be required to establish a violation of the rule



# Rule Gives Rise Only to SEC Remedies

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- Section 206 does not create any private remedies, so the new rule under it would only give rise to potential Commission proceedings
- The new rule does not purport to create any new fiduciary duties
  - The *Goldstein* court took pains to establish that an adviser owes its duties to the fund, not to the investors.



# Proposed Accredited Investor Standards for “Private Investment Vehicles”

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- The SEC is worried about the “retailization” of hedge funds
  - “of significant concern is the growing exposure of smaller investors, pensioners, and other market participants, directly or indirectly, to hedge funds. Hedge fund investors are no longer limited to the very wealthy”
  - concern over inflation since 1982 and the number of individuals who meet the definition of accredited investor
    - especially, concern with the inclusion of the increased value of personal residences in that determination



# Higher Standards for “Private Investment Vehicles”

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- The SEC proposes to establish a higher standard of “accredited investor” status for hedge fund investors
  - Only applies to individuals
  - SEC concerned that they “may find it difficult to appreciate the unique risks of these pools, including those related to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools’ anticipated returns”



# Definition of “Private Investment Vehicles”

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- Any fund relying on section 3(c)(1) of the Investment Company Act (a private fund with 100 or fewer owners)
  - excludes investment companies and 3(c)(7) funds because the former should be registered and the latter already imposes the higher “qualified purchaser” standards to participate
  - there is no consideration of any “lock-up” period



# Definition of “Accredited Natural Person”

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- Piggybacks onto the existing definition of “accredited investor” for natural persons (net worth in excess of \$1 million or meet certain income tests)
- Would require, *in addition to the existing standards*, that the natural person investor own not less than \$2.5 million in **investments**, net of related debt



# Definition of “Accredited Natural Person”

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- Definition of “investments” similar to that for “qualified purchaser” under 3(c)(7)
  - Joint investments of husband and wife only count 50% unless the new investment is joint
- The \$2.5 million would adjust April 1, 2012 and every five years thereafter



# Definition of “Accredited Natural Person”

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- No grandfathering, even for funds in which an investor is already invested
- No special provision for fund employees; SEC notes availability of
  - Allowing non-accredited investors
  - Reliance on Section 4(2)
  - Reliance on Rule 701
  - Contractual, non-security arrangements

# Comments Sought

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- The SEC is seeking comment on many aspects of the proposals, including:
  - Is a two part test for “accredited natural person” the way to go?
  - Is \$2.5 million the right level of investments?
  - Should there be some grandfathering?
- Comment period ends March 9, 2007



*Thank you*



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