

## Appeals Court Overturns SEC Rule Requiring Registration of Hedge Fund Managers: Is It Really Game-Over?

### Introduction

On June 23, 2006, the DC Court of Appeals ("Court") invalidated certain rules promulgated by the US Securities and Exchange Commission (the "SEC") late in 2004 under the Investment Advisers Act of 1940 (the "Advisers Act") that resulted in many hedge fund advisers registering with the SEC.<sup>1</sup> Rule 203(b)(2)-2 under the Advisers Act, sometimes referred to as the "Look-through Rule," required hedge fund managers to count as clients each investor in one of its hedge funds. Before that rule was enacted, each hedge fund, rather than each investor within a hedge fund, was counted as a client and most hedge fund managers avoided Advisers Act registration by relying on an exemption for advisers with fewer than 15 clients (so long as none are registered investment companies). The Look-through Rule generated significant outrage at the time it was published. Since then, however, antipathy to the rule diminished as the hedge fund industry adjusted to the new reality and many managers registered with the SEC.

The suit against the SEC leading to the invalidation of the Look-through Rule was not considered likely to succeed. With the suit's success comes uncertainty, however, and disequilibrium for hedge fund managers. Only with hindsight will we know whether the regime being swept out is preferable to what lies ahead.

We will soon learn more about the SEC's regulatory agenda as the Court subsequently issued an order delaying the date of effectiveness until seven days after the disposition of any timely petition by the SEC for rehearing or rehearing *en banc*. The SEC has until August 7, 2006 to file such a petition. Alternatively, the SEC may appeal directly to the US Supreme Court. A June 23, 2006 statement by SEC Chairman Christopher Cox in response to the decision was non-committal and did not give an indication regarding the SEC's response to this decision.

This Alert summarizes our recommendation to clients and provides a brief analysis of the Court's opinion.

### Our Recommendations to Clients

At this point in time, the effects of the Court decision are not clear; although it is very important to note that the Court's subsequent order staying the effectiveness of the June 23, 2006, order means that the Look-through Rule *is still in effect*. The SEC can appeal the decision, can attempt to modify the Look-through Rule to meet the Court's objections and propose a more palatable alternative,

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We will update this Investment Funds Alert and provide additional guidance to clients as more information becomes available. For further information regarding the Court's decision or actions that you should take, please contact your lawyer at White & Case or any member of the Investment Funds Practice.

or can take no action. Because of the significant ramifications of registering or de-registering as an investment adviser, we recommend that clients carefully consider all factors before choosing to register or de-register at this time and wait for the SEC's next step.

- Advisers who were in the process of registration or contemplating registration as an adviser solely because of the Look-through Rule should consult their White & Case lawyer. Because the rule technically is still in effect, there is a degree of risk to waiting to see whether the SEC appeals this decision or modifies the Rule.
- Advisers who are registered with the SEC and are now Qualified Professional Asset Managers ("QPAMs") under ERISA, or who advise registered investment companies, should not de-register. The elimination of the Look-through Rule does not change the necessity of registration for these advisers.
- Advisers who choose to de-register should consider the impact on (and ire of) existing investors, the need to disclose such de-registration to them and to amend fund documentation and the possible necessity of state registration in the absence of federal registration.
- Advisers based outside the US and who exclusively advise non-US funds and were not subject to all of the provisions of the Advisers Act ("Registration Lite") should watch to see the SEC's response to the decision. For this group of advisers, de-registration is especially appealing and has little downside compared to the implications for US-based advisers. However, we recommend waiting for indications from the SEC as to its intentions, or for the SEC to publish guidance addressed to these managers, before taking action.
- Should an adviser choose to de-register, this should be disclosed to investors. Investors who have entered a fund since the adviser has registered may need to be given the right to redeem their interests in the fund, as the registration status of the adviser could be deemed to be material.

Again, we recommend that clients wait to assess the SEC's response to the ruling before taking any action, absent a compelling business reason to the contrary.

### Summary of the Court Decision

The case was brought before the court by petitioners Philip Goldstein, Kimball & Winthrop, and Opportunity Partners L.P. (collectively "Goldstein") who challenged the Look-through Rule by arguing that the SEC incorrectly equated the term "client" with "investor."<sup>2</sup> Goldstein's main complaint was that the SEC's action misinterpreted Section 203(b)(3) of the Advisers Act and that the SEC's interpretation falls outside of the agency's authority and in turn frustrates the original Congressional intent.<sup>3</sup>

The Court rejected the SEC's arguments in the case. First, the Court stated that even though the term "client" does not have a statutory definition, this does not automatically render the meaning of the word ambiguous.<sup>4</sup> Furthermore, the Court found that previous amendments to the Advisers Act suggest that Congress intended that investment company entities, and not their shareholders, were the advisers' clients.<sup>5</sup> In addition, while the Advisers Act does not define "client," it does define "investment adviser" as one who directly advises a client to invest, purchase, or sell securities. Because the hedge fund adviser does not directly advise the fund's investors ("the adviser does not tell the investor how to spend his money; the investor made that decision when he invested in the fund"), it follows that the entity controlling the fund is not an investment adviser to the investors and thus each investor cannot be a "client" of the fund adviser.<sup>6</sup> In rejecting the SEC's new definition of client, the Court cited the SEC's position prior to that, "an adviser to an investment pool manages the assets of the pool on the basis of the investment objectives of the participants as a group, it appears appropriate to view the pool – rather than each participant – as client of the adviser,"<sup>7</sup> and the Supreme Court's view that the fiduciary relationship that the Advisers Act was created to regulate "exists between the adviser and the fund but not between the adviser and the investors of the fund."<sup>8</sup> Therefore, the Court concluded that the SEC's interpretation

of the word “client” in the Look-through Rule “comes close to violating the plain language of the statute” and “at best it is counterintuitive to characterize the investors in a hedge fund as the ‘clients’ of the adviser.”<sup>9</sup>

The Court also held that the Look-through Rule is unreasonable even though the rule may not violate the plain language of the statute. The Court found that under the Advisers Act, an adviser owes fiduciary duties solely to the fund and not to the fund’s investors because a duty to both would inevitably lead to conflicts of interest. The SEC argued that the Look-through Rule only changed the way of counting clients and does not alter the fiduciary duties owed by the investment adviser. However, according to the Court this argument lacks merit because the SEC cannot explain why the same word, “client,” used in different parts of the same statute has different meanings.

The SEC also attempted to justify the reasonableness of its rule by citing three recent shifts in the hedge fund industry: (i) growth of hedge fund assets by 260 percent from 1999 to 2004; (ii) a trend toward “retailization” of hedge funds because of the increased investment in hedge funds by pension funds and other institutions; and (iii) an increase in fraud actions brought against hedge funds.<sup>10</sup> However, the Court held that the SEC’s arguments lacked merit because there is no relation between the shifts cited and the rule that was created. There is no evidence to support the fact that the advisory relationship between advisers and investors has changed or has caused these trends cited and therefore the Court concluded that the rule was arbitrary and capricious.<sup>11</sup> In addition, the court held that because the SEC has not shown any change in the nature of investment adviser-client relationships, the SEC has failed to justify departing from its own prior interpretation of Section 203(b)(3).<sup>12</sup>

The SEC further attempted to justify the rule by arguing that continuing to treat investors of a hedge fund as a single client, under Section 203(b)(3) would frustrate Congress’ original intent. The SEC argued that Congress intended to exempt only those advisers whose activities were not large scale or national in scope. Therefore, because hedge funds have currently become national in scope, the SEC reasoned that investors

should count as clients to prevent hedge fund advisers from avoiding registration requirements. The Court struck down these arguments by stating that the Look-through Rule bears no rational relation to achieving the supposed Congressional intent (of which there is no evidence in the statute’s text or legislative history). The Court stated that the number of investors in a fund does not reveal any information about the scope or scale of a fund’s activities, the proper indicators of the fund’s importance to national markets are the volume of assets under management or the extent of indebtedness of the hedge fund.

Based on the factors above, the court concluded that the Look-through Rule is unreasonable and arbitrary and vacated the rule.

## Conclusion

The Court’s decision to vacate the Look-through Rule may only be a temporary break in the SEC’s efforts to further regulate alternative asset managers. Congress may be urged to evaluate the regulation of private funds or the SEC may take a radically different approach. In either case, it is unclear which regulatory scheme will prevail.

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1 Goldstein v. SEC, No. 04-1434, at 1,19 (D.C. Cir. 2006).

2 Id. at 2.

3 Id. at 8.

4 Id. at 8.

5 Id. at 11.

6 Id. at 11-12.

7 Id. at 12.

8 Goldstein, No. 04-1434, at 13.

9 Id. at 14.

10 Id. at 7.

11 Id. at 16.

12 In 1985 the SEC adopted a “safe harbor” for general partners of limited partnerships, which enabled them to count the partnership as a single “client” for the purposes of §203. The safe harbor remains part of the SEC’s rules and has been expanded. Id. at 17-18.

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