

Commentary: Goldstein Overruled

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In 2006, the DC Circuit Court of Appeals vacated the rule promulgated by the SEC that required a hedge fund manager to register as an investment manager when the funds managed by the manager had more than 15 investors. This famous case made something of a celebrity out of Phil Goldstein, the manager of Bulldog Investors, who personally litigated this issue against the SEC.

For what it's worth, I erroneously predicted that Mr. Goldstein would lose this case, and I continue to believe it was wrongly decided. Nevertheless, the DC Circuit's decision effectively precluded SEC regulatory supervision of the hedge fund industry.

At the time, the Federal Reserve was beginning to take an interest in the burgeoning hedge fund industry. Although the SEC was not necessarily eager to regulate hedge fund advisers, it was determined not to lose its jurisdiction over the industry to the Fed. As the financial crisis unfolded, calls for the regulation of the industry became difficult to ignore. At this time, there are several proposals to regulate hedge funds circulating in Congress.

In its White Paper proposal for reform of financial services regulation, the Obama Administration discussed a need to regulate hedge funds by causing their advisers to register with the SEC. The proposal also mentioned that the Fed should regulate those hedge funds large enough to be classified as "Tier-1 Financial Holding Companies." On July 15, the Administration unveiled its proposed legislation entitled the "Private Fund Investment Advisers Registration Act of 2009." Now we have a better idea what the Administration has in mind.

It turns out that the both the SEC and the Fed would regulate hedge funds under the Administration's proposal. Those who favor a lighter touch in regulation generally would prefer the SEC over the Fed; regulation by both agencies would change dramatically the way hedge funds operate.

The current version of the Investment Advisers Act requires federal registration of investment advisers that manage more than \$30 million of assets for more than 15 clients. The SEC's ill-fated Hedge Fund Rule attempted to treat the investors in a hedge fund as "clients" for purposes of determining whether or not a hedge fund

adviser was required to register, reversing a long-standing administrative position. The SEC's statutory construction was a bridge too far for the Court of Appeals, which thought a hedge fund should be counted as a single client and ruled that by reversing its previous position, the SEC had exceeded its rule-making authority.

The Administration's proposal would simply eliminate the exemption for advisers that have fewer than 15 clients. One client would be sufficient to require an investment adviser that managed more than \$30 million in assets to register. As a result, managers of private equity and venture capital funds, who would have been exempt from registration under the Hedge Fund Rule, would be required to register. The proposal would also eliminate the exemption for investment advisers whose clients are all from a single state and investment advisers registered with the CFTC as Commodity Trading Advisors. The Administration's proposal would also sweep within its grasp foreign investment managers of more than \$25 million of assets attributable to US investors. Finally, the proposal would authorize the SEC to define terms in the Investment Advisers Act (especially including the term "client") as it determines necessary to effect the purposes of the Act, a provision clearly intended to prevent further judicial activism by the DC Circuit.

Hedge funds would not be required to register under the Investment Company Act. But, the Administration's proposal would require hedge fund managers to make confidential reports to the SEC and disclosures to investors that are similar to investment company requirements. Accordingly, hedge fund managers would be required to make confidential reports to the SEC regarding the amount of assets under management, use of leverage, counterparty credit risk exposures, trading and investment positions and trading practices. Hedge fund managers would also be required to provide disclosures to investors prescribed by the SEC. Last, but not least, hedge fund managers would be subject to periodic and special examinations by the SEC.

Going beyond the Investment Company Act, the SEC would be required to share the confidential information it obtains from a hedge fund manager with the Fed and a newly-created Financial Services Oversight Council. The SEC would also be required to obtain and share other information from hedge fund managers that it determines, after consultation with the Fed and the Council, is necessary to protect investors or for the assessment of systemic risk.

In principle, the purpose of sharing information with the Fed and the Council is to determine whether a hedge fund presents a systemic risk or should be designated a Tier-1 Financial Holding Company. But, there's nothing in the proposal that would limit the information the SEC is required to share with the Fed.

A hedge fund with slightly more than \$30 million of assets under management is unlikely to present much of a risk to the US financial system. Nonetheless, the fact

is that hedge funds managed by advisers with similar investment strategies tend to make the same investments at roughly the same time. During the recent financial crisis, many hedge funds headed for the exits at the same time, resulting in tremendous downward pressure on asset prices. So, while a single hedge fund is unlikely to present a systemic risk, 10,000 hedge funds with similar investment strategies may bring the system to its knees.

Assuming the Administration's proposal is enacted in roughly its current form, which in my view is highly probable, hedge funds managers that were for all practical purposes unregulated will now confront two very powerful regulators. This means that hedge fund managers would be required to spend a lot of time and money preparing an assortment of reports and dealing with SEC examinations. But, that is the least significant part of the Administration's proposal.

It is much more important that hedge funds will be supervised, if somewhat indirectly, by the Fed, acting in its new role as the systemic regulator. It seems to me that, if systemic oversight is what it purports to be, the Fed will from time to time order 10,000 hedge funds to stop buying or selling some investment, or perhaps restrict the exercise of some favorite investment strategy. This sort of regulatory intrusion into investment activity would be a most unwelcome novelty for any investment adviser.

The hedge fund industry's fondest dreams were fulfilled when the DC Circuit vacated the SEC's Hedge Fund Rule at Phil Goldstein's request. This just proves the old adage: "You should be careful what you wish for."

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