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Emerging Developments in Hedge Fund Law

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Overview

The much-maligned hedge fund adviser registration rule at issue in the *Goldstein v. SEC*[1] case clearly demonstrated the Securities and Exchange Commission's commitment to more comprehensively regulate the hedge fund universe; however, how the SEC will achieve this goal is uncertain. In the months following the *Goldstein* decision the SEC has proposed a new antifraud rule, a new "accredited investor" standard for private offerings, and may be using soft dollar rules to regulate hedge fund advisers. Nevertheless, regardless of the SEC's success in regulating hedge funds either directly or indirectly, hedge fund managers should note their common law obligations to act as fiduciaries of hedge funds.

The SEC Proposes New Rules for Hedge Funds

Proposed Antifraud Rule

In *Goldstein*, the court determined that a "client" of a hedge fund adviser for the purpose of the antifraud provisions in Sections 206(1) and 206(2) Investment Advisers Act of 1940 is the *fund itself* rather than the *underlying investors* in that fund. Therefore, as such antifraud provisions are applicable only to the adviser-client relationship, hedge fund advisers owe duties (including fiduciary duties) only to the hedge fund itself and *not* to the individual investors in that hedge fund.

In reaction to the outcome in *Goldstein* , the SEC has offered the Proposed Antifraud Rule (Proposed Rule 206(4)-8), which would prohibit hedge fund advisers from (1) making false or misleading statements to hedge fund investors or to prospective hedge fund investors, or (2) otherwise defrauding such investors. Under the Proposed Antifraud Rule, hedge fund advisers would be prohibited from making any untrue statement of material fact to any investor or prospective investor in the hedge fund, or omitting material facts that are necessary to make statements made to any investor or prospective investor, in the light of the circumstances, not misleading. Thus, a hedge fund adviser would be prohibited from making materially false or misleading statements about the hedge fund's investment strategies, risks, or performance; the adviser's experience and credentials; the valuation of the hedge fund or investor accounts therein; and the adviser's operation of its advisory business. Further, the Proposed Antifraud Rule would prohibit fraudulent, deceptive, or manipulative acts, practices, or courses of business on the hedge fund adviser's part (thereby making the antifraud provisions applicable to conduct not involving statements).

Proposed Private Offering Rules

Currently, Regulation D under the Securities Act of 1933, which is frequently relied upon by hedge funds in offering and selling their securities, provides a safe harbor from registration for private placements to an unlimited number of "accredited investors" and to up to 35 non-accredited investors. With regard to natural persons, the term "accredited investor" in Regulation D includes a person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000 at the time or purchase, or whose individual income exceeds $200,000 (or joint income with that person's spouse of $300,000) in the two most recent years and who expects to reach the same income level in the year of investment. This definition has not been extensively revised since its adoption in 1982.

The SEC's two Proposed Private Offering Rules (Proposed Rules 509 and 216 under the 1933 Act) would amend Regulation D to create a higher threshold for accredited investors who buy hedge fund shares in private placements. The Proposed Private Offering Rules would def ine a new category of accredited investor—the "accredited natural person"—that would apply to offers and sales of securities by hedge funds to natural persons. Under the proposal, an "accredited natural person" would have to meet not only the net worth or income requirements of the current "accredited investor" definition, but also would have to own (individually, or jointly with that person's spouse) not less than $2.5 million (as adjusted every f ive years for inflation) in "investments" at the time the securities are purchased pursuant to Regulation D (as currently defined in the investment company act of 1940). A person’s equity securities, commodities, and cash and real estate held for investment purposes would qualify as “investments” to satisfy the $2.5 million threshold. However, only 50 percent of a person’s investments held jointly with that person’s spouse would be included in the $2.5 million calculation.

The Proposed Private Offering Rules would apply only to hedge funds that rely on the exception from the definition of “investment company” provided in Section 3(c)(1) of the 1940 Act, but would not apply to hedge funds relying on the Section 3(c)(7) exception in the 1940 Act (as the latter exception already imposes a higher “qualif ied purchaser” standard). Further, the Proposed Private Offering Rules would grandfather current accredited investors only to the extent of their current investments in a hedge fund; thus, current accredited investors would also have to meet the new “accredited natural person” standard in order to make additional investments.

In keeping with common law fiduciary requirements, the Proposed Private Offering Rules would impose upon hedge fund advisers the duty to act prudently in selling shares of the hedge fund. As such, hedge fund advisers will have to modify their current subscription agreements between the hedge fund and new investors (or current investors seeking to make additional investments) to ensure that such investors meet the minimum asset and income requirements to qualify as “accredited investors” and maintain suff icient “investments” to qualify as “accredited natural investors.” Revised investor questionnaires would likely be necessary for such a task.

On December 27, 2006, the SEC issued a release addressing two objectives with respect to certain pooled investment vehicles, including hedge funds. Firstly, it proposed a rule that would prohibit hedge fund advisers from making false or misleading statements or otherwise defrauding investors or prospective investors in those hedge funds. Secondly, it proposed two rules that would revise the def inition of “accredited investor” in the private offering context to further restrict the number of persons able to invest in hedge funds.[2] The proposed rules address two aspects of investor protection that the SEC views as necessary in light of the uncertainties created by the *Goldstein* case.

The SEC is seeking comments on the proposed rules, which must be received by March 9, 2007.

The SEC May Regulate Advisers Using The Soft Dollar Safe Harbor

While the decision in *Goldstein* impinged upon the SEC’s ability to regulate hedge fund advisers, the SEC is not without means of regulating hedge funds. One such way of regulating hedge fund advisers is that of using the soft dollar safe harbor (under Section 28(e) of the Securities Exchange Act of 1934) that took effect on January 24, 2007.,/p>

The SEC’s soft dollar safe harbor, as issued in July of 2006, applies to situations in which a hedge fund adviser receives research or brokerage products or services from a broker-dealer in exchange for placing transactions with that broker-dealer, often involving the adviser paying more than the lowest possible commission rate for such services (a breach of the hedge fund adviser’s fiduciary duty). The SEC’s soft dollar safe harbor clarif ies the proper standards for soft dollar commissions.

Detecting a hedge fund adviser’s non-compliance with the new soft dollar safe harbor will be relatively easy to discern when the SEC conducts an audit of the hedge fund’s executing broker. When the trading record between the hedge fund adviser and the broker-dealer is audited, the SEC may determine that some trades did not comply with the soft dollar safe harbor; thus, any commission not in compliance with the soft dollar safe harbor would be suspect. Indeed, a hedge fund’s trading strategies may be inimical to a broker’s need to comply with the soft dollar safe harbor. For instance, while a hedge fund might “cure” its decision to trade outside of the soft dollar safe harbor by merely disclosing its activities, the registered investment adviser or executing broker’s liabilities under the soft dollar safe harbor cannot be cured by mere disclosure; such investment adviser or executing broker must comply.

The SEC’s recent no-action guidance on the issue of the soft dollar safe harbor is also noteworthy.[3] In the noaction letter, the SEC declined to take action against a money manager that had a commission-sharing arrangement under the soft dollar safe harbor with the broker-dealer for the money manager’s accounts. Under the arrangement, a portion of the commissions paid on the money manager’s accounts were allocated to a pool of funds from which the money manager could direct the broker-dealer to pay certain service providers for providing research products and services to the money manager. The SEC determined that the service providers receiving such payments need not be registered broker-dealers for a number of reasons: (1) the money manager independently determined the value of the research services in accordance with its good faith determination under the soft dollar safe harbor; (2) the broker-dealer was not involved in determining the value of the research services; (3) the service provider was paid from a pool of commissions that, under the agreement between the broker-dealer and the money manager, had been set aside for obtaining research services; (4) the service provider’s payment was not conditioned on the execution of any transactions analyzed in the research services; and (5) the service provider did not perform other functions characteristic of brokerdealer activity, including disseminating quotations, handling customer orders, dealing with customer securities account, executing or settling securities transactions, and the like. Thus, service providers paid from a pool of funds generated by commissions on a money manager’s accounts need not be registered as broker-dealers when being paid for their research services (and not broker-dealer activities), as such payments do not resemble “commissions.”

Current Trends Toward De-Registration of Hedge Funds

Following the *Goldstein* court's invalidation of the registration rule for hedge fund advisers, many of the hedge fund advisers that rushed to register under the Advisers Act to comply with the registration rule subsequently rushed to de-register, hoping to avoid further regulation by the SEC. But merely because a hedge fund is not registered with the SEC does not obviate the hedge fund's need to act as a fiduciary.

For example, the SEC and private plaintiffs have brought actions focused upon the fiduciary obligations of hedge fund advisers. Such actions have addressed issues such as: misappropriation of fund assets; portfolio pumping; misrepresenting portfolio performance; falsif ication of experience, credentials, and past returns; misleading disclosures regarding claimed trading strategies; improper valuation of assets; undisclosed preferential treatment of hedge fund clients at the expense of other clients; and improper compensation and performance fees. Penalties for hedge fund advisers' violations of such f iduciary obligations have included: asset freezing; injunctions from future violations of federal securities laws; disgorgement of ill-gotten gains, plus prejudgment interest; civil monetary penalties; and criminal sanctions.

Fiduciary obligations also play a role in on-site compliance examinations of *registered* hedge fund advisers by SEC examiners. Key compliance examination hot topics identified by the SEC include: side-by-side management of separately managed accounts; side letter agreements; valuation of fund assets; and issues regarding custody.

Footnotes

451 F.3d 873 (D.C. Cir. 2006).

SEC Release Nos. 33-8766 & IA-2576; 17 CFR Parts 230 & 275 (Dec. 27, 2006), available at www.sec.gov/rules/proposed/2006/33-8766.pdf.

SEC No-Action Letter re: Status of Service Providers in Goldman, Sachs & Co.'s Research XPRESS Program (January 17, 2007), available at www.sec.gov/divisions/marketreg/mr-noaction/2007/goldmansachs011707-15a.pdf.