Private Equity Newsletter

Davis Polk & Wardwell

September 2006

After the *Goldstein* Decision: What Should a Hedge Fund Manager Do?

This August, the SEC decided not to appeal an important decision handed down by the U.S. Court of Appeals' ruling in *Goldstein v. SEC*, No. 04-1434 (D.C. Cir. June 23, 2006). The *Goldstein* ruling, which struck down the SEC's new rule regarding the registration with the SEC of hedge fund advisers will have a number of implications on the hedge fund industry. The ruling left many hedge fund advisers wondering whether they should continue to seek registration or, having already registered, file papers to deregister. While registration imposes substantial obligations on hedge fund managers, some managers may decide to remain registered (or voluntarily submit to registration) either in response to investor demand or in order to obtain additional pension plan investors.

The *Goldstein* ruling has significantly changed the regulatory topography. No longer is there any need for many managers to become registered and become subject to costly compliance programs, recordkeeping requirements and inspections. At the same time, the SEC continues to have a substantial legal basis to regulate certain activities of hedge fund managers, and thus it would be prudent for managers to keep most of their recently enacted compliance programs intact, even though the SEC may no longer have the right to require registration and submission to regular, periodic inspections.

Should a Registered Hedge Fund Adviser Deregister?

The effect of the *Goldstein* decision is to render unenforceable the hedge fund adviser registration rule. This means, for example, an adviser would not need to rely on the lock-up exception to the hedge fund rule in order to avoid counting the investors in its funds as clients. It is important to note, however, that currently registered advisers—even if no longer required to be registered—remain subject to the Investment Advisers Act of 1940 (the "Advisers Act") applicable to registered advisers for as long as they remain registered. Advisers who wish to deregister will need to file a Form ADV-W with the SEC to withdraw their registration. An adviser's deregistration pursuant to Form ADV-W does not become effective until the Form is affirmatively reviewed and determined not to be deficient by the staff of the SEC.

While the option of deregistering is now available, many hedge fund advisers that registered as a result of the hedge fund rule (estimated to be more than 1,200) may decide to wait and see what short- and mid-term developments occur at the SEC and in Congress before deciding to withdraw their registration. Under the Advisers Act, registrants will need to continue to maintain business records, establish compliance programs and maintain a chief compliance officer; registrants will also be restricted from certain performance fee arrangements and limited in the use of advertising materials.

One drawback to deregistration may be the possible concerns of existing and potential investors. One suspects that this is a relatively modest hurdle to overcome if a fund adviser otherwise has an excellent track record. However, deregistration will need to be explained to investors, and advisers will need to persuade their investors that deregistration will not degrade the advisers' ability to manage money as a proper fiduciary.

Offshore funds and advisers, on the other hand, are likely to act promptly on the ruling by deregistering since they were swept up by the hedge fund rule even though their principal place of business was not in the U.S. The hedge fund rule required hedge fund advisers located outside of the U.S. that had more than 14 investors who were U.S. residents to register but attempted to ease their compliance burden by requiring them only to comply with certain aspects of the Advisers Act such as the registration requirement, the requirement to keep certain books and records and the required submission to examination by the SEC. Offshore advisers that only advised non-U.S. funds were exempt from many of the substantive compliance requirements such as the rules relating to compliance, code of ethics, performance fees and custody and proxy voting. Despite the exemptions, offshore advisers found the rule particularly onerous because many such managers were already subject to regulation in their home country and did not conduct any separate operations in the U.S.

Investing Benefit Plan Assets

One type of hedge fund adviser that may want to register or remain registered are those that currently manage or wish to manage benefit plan assets that are subject to the Employee Retirement Income Security Act, or ERISA. Benefit plan investors have become very attractive to hedge fund advisers due to the exponential increase in the amount of assets invested in these benefit plans. These pension funds have been investing more and more of their assets in hedge funds. According to a study by the Bank of New York and Casey, Quirk & Associates, a consulting firm, pension plans and other large institutions are expected to invest as much as $300 billion in hedge funds by 2009, up from just $5 billion a decade ago.

Managers of funds that constitute "plan assets" are subject to heightened requirements under ERISA [or analogous provisions of the Internal Revenue Code (the "Code") related to 401(k) plans]. These laws and regulations provide, in essence, that if benefit plan investors beneficially own 25% or more of any class of equity interests in a fund and any of those benefits plan investors is subject to the fiduciary and prohibited transaction provisions of ERISA or the Code, then the assets and transactions of the fund will also be subject to those laws. This 25% test must be met by the fund initially and immediately after each sale, transfer or redemption of any equity interests in the fund. But so long as the benefit plan investors remain under the 25% threshold, the manager of the fund will not be subject to ERISA's fiduciary standards and the transactions by the fund will be free of the prohibited transaction rules of ERISA and the Code.

A recently passed law makes it easier for hedge fund advisers to manage benefit plan assets. The law changes the definition of "plan assets" so that only ERISA pension plans (and 401(k) related plans) are counted toward the 25% threshold, not pension money from government or foreign plans, thus making it possible for a hedge fund adviser to accept unlimited amounts from public or foreign plans and more ERISA regulated funds before it is required to comply with the pension law. For a more detailed discussion on the implications of the new law, please see the August 17th DPW memorandum Pension Protection Act of 2006.

Investors Favor Voluntary Compliance

In spite of the *Goldstein* ruling, some hedge fund registrants are hesitating before deregistering. One unofficial consequence of the SEC's rule-making surrounding hedge funds was to increase investors' desire for transparency. With the number of hedge funds estimated at over 10,000 and assets totaling $1.13 trillion in 2005, up 13% from the previous year, the competition for assets has increased with the focus on greater transparency through regular financial disclosures being one major selling point to investors conducting due diligence on a fund. The fact is that the SEC thinks hedge funds should be monitored and registered and has made this view very clear to the investing public. That a court does not think the regulatory agency has the authority to do so will not likely change the SEC's view that oversight is needed. While a number of bills have been proposed in Congress, it is unlikely that a divided Congress will be able to pass legislation expeditiously in this regard. Meanwhile, the SEC remains committed to devising a method to effectively regulate the industry and certain investors may demand this as more assets (particularly retirement assets) are entrusted in hedge funds.

Hedge fund advisers that deregister should use this as an opportunity to develop compliance programs of their own to protect investors in a sensible manner from insider trading, corruption and other abuses. Hedge funds and their advisers should seek counsel to develop appropriate voluntary compliance programs to increase transparency and self-monitor against potential abuses in order to give less opportunities to critics to call hedge fund practices into question. If and when additional alternative regulations are established by the SEC, Congress or otherwise, these funds and their advisers will be in a good position to comply without sacrificing efficiency or incurring unnecessary expense for the benefit of their investors and their funds.

Please call your Davis Polk contact or Dan Townley (212-450-4240) if you have any questions regarding this newsletter. For a list of Davis Polk's primary private equity lawyers, please click here.
