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HRO Alert

Goldstein v. S.E.C.—

HOW THE SEC TRIED AND FAILED TO CONQUER GOTHAM CITY, AND WHAT IT MEANS IN HEDGE FUND LAND

The big news in hedge fund land is that a federal court has thwarted the Securities and Exchange Commission's first attempt to regulate hedge fund advisers. On June 23, 2006, the U.S. Court of Appeals for the District of Columbia Circuit (*Goldstein v. S.E.C.*) struck down the SEC's rule that attempted to exert greater regulatory power over hedge fund managers. The SEC's rule – for which compliance became mandatory in February 2006 – resulted in many hedge fund managers registering as investment advisers.

We do not think the what's and why's of the *Goldstein* ruling are nearly as interesting – or relevant – as some questions that follow in its wake, such as: What does the ruling mean to hedge fund managers? Does the SEC have a Plan B? Will Congress decide to take over? And does any of this matter?

What does the ruling mean for hedge fund managers? As usual, where you stand is where you sit or, more precisely, where your fund management business is located. The SEC's rule meant little to many U.S. hedge fund managers. Why? Because they are already registered either with the state in which they are located (if they have \$25 million or less under management) or with the SEC if they have more than that amount under management.

Why did they register in the first place? Because a state can require an investment adviser to register if the adviser has a place of business in that state and is not otherwise registered with the SEC. (This has always been the case.) If an adviser qualified for the SEC exemption that its new rule attempted to shelve, the adviser was then subject to state law registration requirements if (1) it had a place of business in that state, or (2) it had more than five clients in that state. Only about a dozen states have registration exemptions for advisers who have a place of business in their state.

Of course, the State of New York is the elephant in this room, because so many hedge funds are located in New York City. For that reason, the SEC's now-defeated rule could have been called the "New York City Hedge Fund Adviser Registration Rule." Accordingly, the demise of the SEC's rule does not mean much to hedge fund managers located across the U.S. (and there are a lot of them), such as in California, Colorado, Ohio, Texas, Pennsylvania, Utah, and many others. (Wyoming is the only state that does not regulate investment advisers.) Hedge fund managers in those states will continue to register as investment advisers with their states or with the SEC when they cross the effective threshold of \$30 million in assets under management. The new SEC rule did not change this, so it being overturned will not either.

What is next? New York-based advisers, as well as those in other states with similar registration exemptions such as New Jersey, Illinois (if all of the adviser's clients are accredited investors), and even North Carolina, can breathe a sigh of relief. Or can they? That is the big question, and here is why: the SEC will almost certainly try another stab in some fashion at regulating hedge fund managers (assuming it does not appeal

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the latest ruling; a decision it has not made yet, at least publicly). Regardless of what the SEC decides to do, Congress will continue to take a hard, close look at doing something, anything, to mollify constituent demands, real or imagined. To wit, the U.S. Senate Securities and Investment Subcommittee held hearings on hedge funds this spring, and Chuck Hagel, Chair of that Subcommittee of the Senate Banking Committee, promises more in the wake of the *Goldstein* decision. Perhaps most important, however, is that this year many investors for the first time experienced the look and feel of having their fund managers registered as investment advisers, and the investors may very well have liked it. Now that their fund manager is registered, how is he or she going to explain a decision to de-register (assuming of course the SEC can figure out how to let them)?

As a result, do not look for the SEC to do too much too quickly as it tries to find yet another way to untie the giant hedge fund knot. Congress has huffed and puffed against the hedge fund house before (hearings in 2001 in the wake of the "Sound Practices for Hedge Fund Managers" industry report released in February 2000 following the Long Term Capital Management debacle). Without a wider spread Enron-caliber fiasco (Long Term Capital Management being too much a fading, isolated anomaly), Congress may be hard-pressed to advance meaningful legislation that survives the gantlet of the money management and securities industry lobby interests.

Rather, look for any near term pressure to come from the place it probably counts the most: the investor community itself, particularly pension funds and other institutional investors. They have the most interest in hedge fund transparency, strong financial controls, and risk management systems – the purported upshot of the SEC's rule. They also have the clout to mandate manager registration and are likely to consider the increased fund costs (and lower net performance) an acceptable trade off. Fund managers located in the non-elephantine states will continue along as they always have – running hedge fund operations as a regulated adviser.

Finally, do not put it past the State of New York to revisit its investment adviser registration exemption without which many Gotham City fund managers would be required to join their sistren and brethren in the majority of states that require registration.

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