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Goldstein v. SEC

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Hedge funds have grown rapidly in the last few years.[1] Eight thousand eight hundred hedge funds are believed to exist today with aggregate assets totaling upwards of $1.2 trillion.[2] Major hedge fund losses, such as that of Long-Term Capital Management, which lost $4 billion in five weeks,[3] have brought increased attention to a field that is known for high-risk investment strategies and high returns,[4] as well as for being secretive,[5] unregulated,[6] and accessible only to wealthy investors.[7] The industry has seen an increase in institutional investors and many people fear that "retailization" of hedge funds is opening up the playing field to a broader audience.[8] In response to these changes in the hedge fund industry and the view that there has been an increase in fraudulent activities among hedge fund investment advisers,[9] the Securities and Exchange Commission ("SEC")[10] has been studying the need for regulation and investigating methods to increase oversight of hedge funds.[11] There is a growing divide between those who perceive hedge fund growth as a black hole in dire need of federal regulation[12] and those who assert that the absence of federal regulation is the nature of the industry, and the reason why hedge funds generate such high returns. Furthermore, those that make the latter contention believe that our financial markets rely upon the absence of federal regulation of hedge funds.[13]

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1. *Regulation of Hedge Funds: Hearing Before the U.S. S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2006) [hereinafter Cox] (statement of Christopher Cox, Chairman, Sec. & Exch. Comm'n) (estimating that hedge fund assets have increased 3,000 percent over the last sixteen years); *see also* Dale A. Oesterle, *Regulating Hedge Funds* (Public Law and Legal Theory, Working Paper Series No. 71 & Center for Interdisciplinary Law & Policy Studies Working Paper Series No. 47, 2006), *available at* http://ssrn.com/abstract=913045 [hereinafter Oesterle]; David A. Katz and Laura A. McIntosh, *Advice on Coping With Hedge Fund Activism,* N.Y.L.J., May 25, 2006, at 5.
2. Cox, *supra* note 1.
3. *Id.* ("Had the Federal Reserve Bank of New York not intervened to organize a $3.6 billion bailout by the fund's creditor banks, the bankruptcy of LTCM 'could have potentially impaired the economies of many nations, including our own.'" (quoting then Federal Reserve Bank Chairman Alan Greenspan)).
4. *See* Oesterle, *supra* note 1.
5. *Id.*; *see also, e.g.,* Joseph Nocera, *Offering Up an Even Dozen Odds and Ends,* N.Y. TIMES, Dec. 24, 2005, at C1.
6. *See* Oesterle, *supra* note 1. Hedge funds owe much of their success to exemptions from federal regulation on formation, organization, and trading practices. *Id.*
7. *Id.* ("People who distrust the wealthy elite see hedge funds as the exclusive playground of a very wealthy elite class of investors.").
8. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,057–72,058 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279) [hereinafter Final Rule]. Institutional investors include investment companies and investment banks, private and public pension plans, endowments, and foundations. *Id.*
9. *Id.*
10. The SEC is responsible for regulating money managers. 15 U.S.C. § 80b-1 (2000).
11. Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006).
12. *See generally* Final Rule, *supra* note 8.
13. *See* Oesterle, *supra* note 1.

In *Goldstein v. SEC*, the U.S. Court of Appeals, District of Columbia Circuit, was called upon to review the SEC's Hedge Fund Rule, which attempted to regulate hedge funds under the Investment Advisers Act of 1940 ("Advisers Act"), and required most hedge fund investment advisers to register with the SEC.[14] The D.C. Circuit addressed the issue of whether the term "client" in Section 203(b)(3) of the Advisers Act could be construed to include the "shareholders, limited partners, members, or beneficiaries" of a hedge fund.[15] Previously, the SEC had interpreted the term client to include only the funds of investment advisers and not the funds' investors.[16] The *Goldstein* court, however, threw out the SEC's Hedge Fund Rule and unanimously held that the SEC had exceeded its statutory authority, and that its interpretation of the term client in Section 203(b)(3) of the Advisers Act was arbitrary and unreasonable.[17] This case comment contends that while the court's decision to vacate the Hedge Fund Rule was correct, it resulted in much confusion among hedge fund investment advisers who had registered to comply with the Hedge Fund Rule because the court failed to delineate the protections that remained for newly registered hedge fund investment advisers and the procedures for deregistration. In vacating the Hedge Fund Rule, the court also threw out a number of amendments that were created to protect hedge fund investment advisers who were forced to register under the new rule.[18] The entire rule and related amendments (the "entire adopting release") protected newly registered hedge fund investment advisers by relieving them of the immediate need to comply with the books and records and compensation requirements, among other things. By vacating the entire adopting release the court sowed confusion among hedge fund investment advisers.

Previously, under Section 203(b)(3) of the Advisers Act, hedge fund investment advisers who had fewer than fifteen clients were exempt from registration with the SEC.[19] The SEC had interpreted the term client to mean the entity, rather than the individual investors of the entity.[20] In 2004, with a view toward increasing federal regulation of hedge funds and their investment advisers, the SEC sought comments from the industry regarding its proposed Hedge Fund Rule.[21] The SEC received 161 letters from investors, hedge fund advisers, other investment advisers, trade associations, and law firms. In total, forty-two did not take a position on registration, thirty-six approved the rule to increase hedge

14. *Goldstein*, 451 F.3d at 874.

15. *Id.* (quoting 17 C.F.R. § 275.203(b)(3)-2(a) (2007)).

16. *Id.* at 876.

17. *Id.* at 881–84.

18. *See* Final Rule, *supra* note 8.

19. *See* 15 U.S.C. § 80(b)-3(b)(3) (2000).

20. *Goldstein*, 451 F.3d at 876.

21. *See* Final Rule, *supra* note 8.

fund regulation, and eighty-three dissented.[22] Despite strong opposition from the hedge fund community and two dissenting commissioners regarding the registration requirement and its costs, dubious ability to prevent fraud, and intrusiveness,[23] on December 1, 2004, the SEC adopted the Hedge Fund Rule and related amendments that mandated that private funds "look through" the entity and count the "shareholders, limited partners, and beneficiaries of the fund" as "clients."[24] This adoption forced hedge fund investment advisers to register with the SEC before February 1, 2006,[25] effectively eliminating their prior exemption from registration under the Advisers Act and abolishing a 1985 statutory safe harbor.

Plaintiffs Philip Goldstein, Kimball & Winthrop (an investment advisory firm co-owned by Goldstein), and Opportunity Partners L.P. (a hedge fund in which Kimball & Winthrop was the investment adviser) (collectively, "Goldstein") filed a petition for review of the SEC's Hedge Fund Rule.[26] Plaintiffs argued that the SEC's regulation of hedge funds under the Hedge Fund Rule was contrary to Congressional intent, and that the SEC's attempt to redefine the term client exceeded its statutory authority.[27] Furthermore, plaintiffs contended that the SEC's interpretation of the statutory language was unreasonable and arbitrary for a number of reasons.[28] First, the SEC did not provide evidence of a change in the nature of the relationship between hedge fund investment advisers and clients of funds to justify departing from its prior usage of the term.[29] Also, the SEC failed to provide a reasonable justification for why client should mean something different for the purpose of the hedge fund investment adviser exemption than what it means for other provisions of the same act.[30] According to the plaintiffs, the SEC's usage of the term client was illogical in that a hedge fund investment adviser does not have a direct and personal relationship with a security holder and cannot owe fiduciary duties to both the entity and the security

22. *Id.*

23. *Id.*

24. *Goldstein*, 451 F.3d at 877; 17 C.F.R. § 275.203(b)(3)-2(a) (2007).

25. *See* Final Rule, *supra* note 8.

26. *See* Initial Brief: Appellant-Petitioner, Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (No. 04-1434). Plaintiff filed a petition with both the District Court and the Court of Appeals because of ambiguity regarding the review process. It is generally said that review by the Court of Appeals is proper because it saves time and money. Both parties agreed that the petition should be reviewed by the Court of Appeals. Furthermore, the Advisers Act provides for review in a federal appellate court and case law indicates that ambiguities should be resolved in favor of appellate review. In order to save time and meet the grievance deadline, a petition was also filed with the District Court on the chance that the judicial system directed the petition to the District Court. *Id.*

27. *Id.* at 27.

28. *Id.* at 24–25.

29. *Id.* at 40.

30. *Id.* at 38–39.

holders of that entity because it would create a conflict of interest.[31] Furthermore, the SEC's evaluation was "arbitrary" and "capricious."[32] Finally, plaintiffs argued that if the SEC desired to reinterpret the term client or increase regulation of hedge fund investment advisers, it must do so by appealing to Congress to amend the Advisers Act.[33]

The SEC argued that the term client in the Advisers Act was ambiguous and that the legislative history did not shed further light on the issue.[34] According to the SEC, the method of counting clients under the Advisers Act was not determined by Congress, and therefore the SEC had the regulatory authority to interpret the meaning of the term.[35] In addition, the SEC asserted that plaintiffs' argument regarding fiduciary duties was invalid because the SEC had made clear that there would be no change in fiduciary duties under the new rule.[36] The SEC asserted that the previous rule was inconsistent with the purpose of the exemption.[37] The growth of the industry, the retailization of hedge funds, and an increase in fraud in the industry further necessitated the rule change.[38] Finally, the SEC argued that it had a right to eliminate the exemption created by Congress in order to safeguard hedge fund investors and the securities markets.[39]

After an extensive review of the meaning of the term client in the Advisers Act, the court vacated the SEC's Hedge Fund Rule.[40] First, the court made clear that just because the term client is not defined in the Advisers Act does not mean the term is ambiguous and that the SEC may impart whatever meaning it chooses.[41] Rather, the meaning of the term must be gleaned from context, the statutory scheme, and the purpose for which it was implemented.[42] The court held that the legislative history surrounding the exemption provided the court with a clear indication of Congress's intent not to regulate hedge fund investment advisers.

31. *See* Reply Brief of Petitioner at 8–9, Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (No. 04–1434).

32. *See* Initial Brief: Appellant-Petitioner, *supra* note 26, at 24.

33. *See* Reply Brief of Petitioner, *supra* note 31, at 3.

34. *See* Brief of the Securities and Exchange Commission, Respondent at 15, Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (No. 04–1434).

35. *Id.* at 20–21.

36. *Id.* at 18.

37. *Id.* at 40.

38. *See id.* at 9–11.

39. *Id.* at 7.

40. Goldstein v. SEC, 451 F.3d 873, 884 (D.C. Cir. 2006).

41. *Id.* at 878 ("The lack of a statutory definition of a word does not necessarily render the meaning of a word ambiguous, just as the presence of a definition does not necessarily make the meaning clear.").

42. *Id.*

Prior to 1970, investment advisers could advise an unlimited number of investment companies without becoming subject to registration, provided they were only advising investment companies. In 1970, Congress amended Section 203 and eliminated a separate registration exemption, which the court explained would have been superfluous if Congress had deemed investors to be clients of advisers.[43]

The fact that Congress did not intend investors of hedge funds to be counted as "clients" is further indicated by Congress's definition of investment adviser in the Advisers Act.[44] The Advisers Act defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[45] The court explained that an investor in a fund does not receive advice directly from the adviser in the sense that the adviser does not tell the investor how to spend his money because the investor has already spent his money when he invested in the fund.[46] Rather, the adviser advises the fund on what to do with its capital.[47] If the adviser is not advising the investor directly, it is impossible for the investor to be a client of the adviser.[48]

The court held that in the Hedge Fund Rule, the SEC had arbitrarily departed from its prior interpretation of the term client.[49] In 1997, the SEC issued a regulation explaining that an investment adviser has no duty to consider the needs of individual investors when investing the fund's capital.[50] Therefore, a fund's investors could not be deemed to be clients. Furthermore, in 1985, the SEC adopted a safe harbor for general partners of limited partnerships and stated that when "an adviser to an investment pool manages the assets of the pool on the basis of investment objectives of the participants as a group, it appears appropriate to view the pool—rather than each participant—as a client of the adviser."[51] Since 1985, this safe harbor has been expanded to include other types

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43. *Id.* at 879 ("Congress eliminated a separate exemption from registration for advisers who advised only investment companies and explicitly made the fewer-than-fifteen-clients exemption unavailable to such advisers." (citing Investment Company Amendment Act of 1970, Pub. L. No. 91–547, § 24, 84 Stat. 1413, 1430 (1970))).

44. *Goldstein*, 451 F.3d at 879.

45. 15 U.S.C. § 80b-2(11) (2000).

46. *Goldstein*, 451 F.3d at 879–80.

47. *Id.*

48. *Id.* at 880.

49. *Id.*

50. *Id.* at 880 (citing Status of Investment Advisory Programs Under the Investment Company Act of 1940, 62 Fed. Reg. 15,098, 15,102 (Mar. 31, 1997)).

51. *Goldstein*, 451 F.3d at 880 (quoting Definition of "Client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 Fed. Reg. 8740, 8741 (proposed Mar. 5, 1985)).

of entities.[52] Because the SEC failed to provide evidence indicating a change in the nature of the advisory relationship between a hedge fund investment adviser and investors to justify such a radical departure from the rule, the court ruled its actions were arbitrary and unreasonable.[53]

The court also noted that a hedge fund investment adviser cannot owe fiduciary duties to both the fund and the individual investors in a fund since it would create a conflict of interest.[54] The court was unimpressed by the SEC's argument that the Hedge Fund Rule would not affect the fiduciary duties owed to a client because, according to the SEC, its new usage of the term would only be applicable to the method of counting clients for purposes of Section 203(b)(3).[55] The court held that the term client could not have two entirely different meanings within the same act.[56]

Lastly, the court rejected the SEC's contention that the Hedge Fund Rule fostered Congress's policy goals under the Advisers Act.[57] Essentially, the SEC argued that Congress did not choose to regulate hedge funds because they were not national in scope.[58] The court held that this was not clearly Congress's intent and furthermore, even if it was, it was not the number of investors in a hedge fund that was the critical factor in assessing its importance to the financial markets, but rather the amount of assets in the fund.[59]

In sum, the court vacated and remanded the Hedge Fund Rule because the SEC had arbitrarily departed from its prior interpretation of the term client[60] and its interpretation under the Hedge Fund Rule was unreasonable.[61] The court stated that "the SEC may not accomplish its objective of more comprehensive regulation of hedge funds by a manipulation of meaning."[62]

This case comment contends that while the court's decision to vacate the Hedge Fund Rule was correct, its holding was too broad. The court essentially "threw the baby out with the bathwater" by overturning the Hedge Fund Rule and its registration requirements and not addressing the entire adopting release. In failing to address the entire adopting release, the court stripped newly registered hedge fund investment advisers of the protections afforded to them under

52. *Id.*
53. *Id.* at 882–83.
54. *Id.* at 881.
55. *Id.* at 882.
56. *Id.* ("[W]e ordinarily presume that the same words used in different parts of a statute have the same meaning.").
57. *Id.* at 883.
58. *Id*.
59. *Id*.
60. *Id.* at 883–84.
61. *Id.* at 881.
62. *Id.* at 882.

the Hedge Fund Rule. The court should have addressed the entire adopting release and made clear what protections would exist for newly registered hedge fund investment advisers and what the legal procedure for deregistration would entail.

As a result of the court's expansive decision in *Goldstein* to vacate the entire adopting release, rather than addressing the related amendments, many hedge fund investment advisers found themselves newly registered without the protections promised to them under the Hedge Fund Rule. The decision led to something short of pandemonium in the hedge fund world. After *Goldstein*, hedge fund investment advisers questioned whether it was prudent to deregister immediately to avoid being in non-compliance or whether to remain registered in case the SEC requested a rehearing of the court or submitted a petition for certiorari to the Supreme Court. Such a rehearing or grant of certiorari would lead to the obvious potential of overruling the decision.

On August 7, 2006, SEC Chairman Christopher Cox issued a statement indicating that since the *Goldstein* decision was unanimous and based on multiple grounds, the SEC would not pursue further judicial action because it believed it stood little chance of obtaining a favorable decision.[63] However, because of the court's decision, legal questions remain regarding the elimination of protections related to issues such as the transitional books and records requirement, the deregistration process, and the performance based compensation allowances, which were promised to newly registered hedge fund investment advisers.

Because *Goldstein* declined to render guidance on the status of the rule amendments, there was a great deal of ambiguity for hedge fund investment advisers regarding the registration and compliance process and the law governing hedge fund investment advisers. In the aftermath of the decision,[64] the American Bar Association ("ABA"), Section of Business Law, submitted a letter[65] dated July 31, 2006, to the Division of Investment Management of the SEC requesting that the SEC clarify and provide interpretative advice regarding the amendments promulgated in connection with the Hedge Fund Rule, which were vacated by default.

One gray area addressed by the ABA letter involved the books and records requirement.[66] Under the prior rules, Section 204–2(a)(16) of the Advisers Act required registered hedge fund investment advisers to maintain books and

63. *Statement of Chairman Cox Concerning the Decision of the U.S. Court Of Appeals in Goldstein, Et Al. v. SEC,* 2006 SEC NEWS DIG. 152 (Aug. 8, 2006) [hereinafter *Statement of Chairman Cox*].

64. *Goldstein*, 451 F.3d at 873.

65. Letter from Paul N. Roth & Jeffrey E. Tabak, Chair & Co-Chair, ABA Subcomm. on Private Inv. Entities, to Robert E. Plaze, Assoc. Dir. of the Div. of Inv. Mgmt., SEC (July 31, 2006) (on file with author), *available at* http://www.abanet.org/buslaw/committees/CL410000pub/comments/20060731000000.pdf [hereinafter ABA Letter].

66. *Id.* at 2–3.

records used to determine performance for marketing and advertising purposes.[67] Amendment 203(b)(3)–1 of the Advisers Act created a transitional exception, whereby newly registered hedge fund investment advisers would not be required to maintain records of fund performance for any period ending prior to February 1, 2005. Now, because of the *Goldstein* decision, without this transitional exemption many newly registered hedge fund investment advisers may not be in compliance with the Advisers Act.

Another problem created by *Goldstein*, and also discussed in the ABA letter, deals with the issue of performance-based compensation.[68] Section 205(a)(1) of the Advisers Act prohibited registered investment advisers from receiving compensation based on the capital gains of the fund unless receiving it from a "qualified client."[69] The Hedge Fund Rule amended this rule and grandfathered existing performance-based compensation plans for hedge fund investment advisers not receiving compensation from qualified clients who were forced to register under the Hedge Fund Rule. When the court vacated the Hedge Fund Rule, it eliminated this protection, thereby potentially causing another compliance problem for many newly registered hedge fund investment advisers.

The issues discussed above are only a few examples of the potential problems and ambiguity resulting from the court's expansive decision. Other gray areas include the treatment of offshore hedge fund investment advisers, extension of the distribution period of audited financials for fund of funds (who rely on audited financials from the funds they invest in to prepare their own audited financials), and issues related to withdrawal from registration (Form ADV–W and balance sheet requirements).[70]

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67. 17 C.F.R. § 275.204–2(a)(16) (2007).

68. *Id.*

69. *Id.* at § 275.205–3(d)(1) (2007). A qualified client is defined as follows:

> (i) A natural person who or a company that immediately after entering into the contract has at least $750,000 under the management of the investment adviser;
>
> (ii) A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either: (A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time the contract is entered into; or (B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 at the time the contract is entered into; or
>
> (iii) A natural person who immediately prior to entering into the contract is: (A) An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or (B) An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

70. *See* ABA Letter, *supra* note 65.

On August 1, 2006, the Division of Investment Management of the SEC responded to the ABA.[71] The Division of Investment Management stated that it would not recommend enforcement action against hedge fund investment advisers not in compliance with the rules if they would have been in compliance under the Hedge Fund Rule and related amendments.[72] While this alleviates a degree of uncertainty left by *Goldstein*, there is still ambiguity that must be resolved.

As a result of the court's decision and the increased attention this case has brought to the area, it is not clear what the law on hedge funds is, nor is it clear what the future holds for hedge fund registration and regulation. However, the *Goldstein* decision did make apparent that the SEC cannot arbitrarily impose unreasonable requirements on hedge fund investment advisers, nor may it exceed its statutory grant of power. In a recent address to the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Commissioner Cox indicated that in the aftermath of *Goldstein*, the SEC will continue to seek ways to regulate hedge funds including limiting access to retail investors by increasing the minimum net worth requirements. He noted, however, that some action may need to be legislative.[73]

By nature, hedge funds are high-risk investments and employ secretive trading strategies.[74] Investors in hedge funds are high net worth, sophisticated clients who are aware of their potentially risky, yet lucrative investments.[75] Heavy regulation has the potential to decrease foreign investment and may create a false sense of security for investors when regulation may not in fact prevent fraud.[76] There are other ways to protect investors, such as increasing the minimum net worth requirements and requesting simple notice filings of hedge funds.[77] But because of the expansive nature of the court's decision in *Goldstein,* and the ambiguity it created, there has been an increased focus on hedge fund related activity ultimately resulting in a frenzy of unjustified regulatory proposals.[78] As a result of the court's expansive decision, it is not clear what protections exist for newly registered hedge fund investment advisers.

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71. Response Letter from Robert E. Plaze, Assoc. Dir. of the Div. of Inv. Mgmt. of the SEC, to Paul N. Roth & Jeffrey E. Tabak, Chair & Co-Chair, ABA Subcomm. on Private Inv. Entities (Aug. 10, 2006).

72. *Id.*

73. *See Statement of Chairman Cox*, *supra* note 63.

74. *See* Oesterle, *supra* note 1, at 10–11.

75. *Id.*

76. *See* Final Rule, *supra* note 8.

77. *See id.* at 72,089–72,098 (Comm'rs Glassman and Atkins, dissenting).

78. *See e.g.,* Securities and Exchange Commission Authority Restoration Act, H.R. 5712, 109th Cong. (2006); Hedge Fund Study Act, H.R. 6079, 109th Cong. (2006).