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## U.S. COURT OF APPEALS INVALIDATES HEDGE FUND INVESTMENT ADVISER REGISTRATION RULE

**To:** **Clients and Friends of Tannenbaum Helpern Syracuse &  
Hirschtritt LLP**

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On Friday, June 23<sup>rd</sup>, the United States Court of Appeals for the District of Columbia Circuit struck down the controversial Securities and Exchange Commission rule (the “Rule”) requiring certain hedge fund advisers to register, calling the Rule “arbitrary” and stating that the Commission “has failed to adequately justify departing from its own prior interpretation of Rule 203(b)-3.”<sup>1</sup>

The opinion stems from the recent SEC hedge fund registration Rule<sup>2</sup>, effective February 1, 2006, which requires advisers to “private funds” with more than \$30 million in assets under management and 15 or more clients to register as investment advisers with the Commission. By amending the definition of “client” in the Rule to include each investor in a “private fund”, the Rule required most hedge fund advisers to register.

In proposing the Rule, the SEC claimed that adviser registration would prevent fraud in the expanding hedge fund industry and justified the Rule based upon the rise in the amount of hedge fund assets, indications that more pension funds and other institutions were investing in hedge funds, and an increase in fraud actions involving hedge funds. In response, the Court stated that “the Commission's rule creates a situation in which funds with one hundred or fewer investors are exempt from the more demanding Investment Company Act, but those with fifteen or more investors trigger registration under the

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<sup>1</sup> See *Goldstein v. U.S. Securities and Exchange Commission*, 2006 WL 17157766, C.A.D.C., 2006.

<sup>2</sup> See former SEC Rule 203(b)-3 under the Investment Advisers Act of 1940.

Advisers Act. This is an arbitrary rule.” The Court vacated and remanded the Rule to the SEC.

SEC Chairman Christopher Cox said “the court's finding, that despite the commission's investor protection objective, its rule is arbitrary and in violation of law, requires that going forward we reevaluate the agency's approach to hedge fund activity. I have instructed the SEC's professional staff to promptly evaluate the court's decision and to provide to the Commission a set of alternatives for our consideration.”

Investment advisers who registered as a result of the Rule now need to consider whether to maintain their registration. Factors to consider include whether they need to be registered for marketing purposes or because they manage ERISA or benefit plan assets. For example, pension trustees and institutions generally prefer registered advisers over non registered ones. Also, before de-registering, an adviser should consider any representations they may have made regarding their registered status in swaps or other derivatives or agreements or in offering materials. All investment advisers, whether or not registered, are subject to the anti-fraud provisions of the Advisers Act, while unregistered investment advisers are relieved from certain compliance rules under the Advisers Act. On the other hand, registered advisers have already established the necessary compliance procedures and investors have placed increasing importance on adviser registration since the Rule became effective.

It remains to be seen what Cox will do. If he doesn't appeal, the Court decision stands. The Securities and Exchange Commission may try to work the substance of the new Rule into the antifraud provisions or may go to Congress for statutory revisions.

If you have any questions or comments regarding the recent United States Court of Appeals ruling, please feel free to contact:

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