The Investment Advisers Act: the need for clarity in the post-Goldstein era

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Abstract

Purpose – *This paper seeks to discuss regulatory clarifications provided by the SEC since the June 2006 DC Court of Appeals decision in Goldstein v. Securities and Exchange Commission disrupted the SEC's hedge fund registration framework and other recently promulgated investment adviser practices and procedures.*

Design/methodology/approach – *Describes recent legislative efforts to reexamine the hedge fund industry and the SEC's response letter on several important issues raised by the American Bar Association Subcommittee on Private Investment Entities; highlights the need for the SEC and/or legislatures to address numerous issues raised by the Goldstein decision.*

Findings – *The SEC's response letter to the ABA Subcommittee on Private Investment Entities provided clarification on recordkeeping requirements for performance information, performance-based compensation, and deadlines for distributing audited financial statements of funds-of-funds to investors. Further actions to be taken by the SEC and/or legislatures are still uncertain on issues such as the applicability of the antifraud provisions of the Advisers Act, the investment adviser accreditation threshold for "accredited investors," liberalization of the manner of offering restrictions, increasing financial tests for individuals qualified to invest in hedge funds, and the necessity for general solicitation restrictions.*

Originality/value – *A useful update on the continually changing regulatory environment for hedge funds by an attorney who specializes in investment fund regulation.*

Keywords *Investment funds, Regulation*

Paper type *Technical paper*

The decision of the United States Court of Appeals for the District of Columbia Circuit in Goldstein v. Securities and Exchange Commission[1] on June 23, 2006 disrupted not only the regulatory framework surrounding the hedge fund industry and investment adviser registration in general but also investment adviser practices and procedures that had been followed since the adoption of Rule 203(b)(3)-2 and amendment of Rule 203(b)(3)-1 as well as related rule amendments[2] of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Not only did the Court of Appeals' decision vacate the rules mandating registration of investment advisers with the Securities and Exchange Commission (the "SEC"), but it also vacated the amendment of other rules of the Advisers Act that served to facilitate the practical operation of hedge fund advisers while satisfying the various registration requirements of the Advisers Act. While the determination of the SEC not to appeal the Court of Appeals' decision was not unexpected, new legislative efforts, along with much needed clarifications by the SEC of existing regulations and its positions with respect to many issues left unanswered in the wake of the Court of Appeals' decision, were expected. These clarifications have assisted hedge fund advisers in continuing to operate either within the registered investment adviser federal regulatory regime or as unregistered investment advisers under state scrutiny in many instances.

Recent bills sponsored by Representative Barney Frank (D-Mass)[3] and Representative Michael Castle (R-Del)[4]are indicative of the recent legislative efforts seeking to reexamine the hedge fund industry and the existing regulatory enforcement framework and to further examine the efficacy of the SEC's ability to extend its regulatory reach in the wake of the post-*Goldstein* decision. Representative Frank's bill, the ''Securities and Exchange Commission Authority Restoration Act of 2006,'' is designed to authorize the SEC to restrict the applicability of the Section 203(b)(3) exemption by requiring that certain investors and limited partners of clients of the investment adviser be counted as clients themselves. The bill in effect would restore the Section 203(b)(3) amendment requiring a ''look-through'' for counting purposes under most circumstances. Representative Castle's bill, the ''Hedge Fund Study Act,'' is centered on requiring the President's Working Group on Financial Markets to conduct a study of the hedge fund industry including analyses of the changing nature of hedge funds, the growth of the industry within financial markets, the growth of pension fund investments into hedge funds, whether leverage is adequately constrained, and whether adequate hedge fund investor protection safeguards are in place. The bill requires that the study report include recommendations including any proposed legislation relating to disclosure requirements for hedge funds, the type of hedge fund information that should be disclosed to regulators and the public, and any oversight responsibilities that the President's Working Group should have over the hedge fund industry. While such proposed legislation may serve to reinstate material provisions of the Advisers Act rules that were vacated, the SEC has taken immediate steps to clarify its position with respect to many unanswered issues.

The recent interpretative guidance by the Division of Investment Management of the SEC in its response letter to the letter submitted by the Subcommittee on Private Investment Entities of the American Bar Association (the ''ABA'') on July 31, 2006 addressing several key matters has helped to clarify certain issues left undetermined and vague after the Court of Appeals' Goldstein decision. The SEC's response letter addressed several important issues raised by the ABA. Among these issues was that of recordkeeping requirements applicable to performance information. Rule 204-2(a)(16) requires a registered investment adviser that utilizes performance information to maintain appropriate records that ''form the basis for or demonstrate the calculation of the performance or rate of return.'' In its adoption of Rule 203(b)(3)-2, the SEC amended Rule 204-2 by adding Rule 204-2(e)(3)(ii) to provide comfort to newly registered investment advisers that may not have maintained appropriate books and records in satisfaction of the recordkeeping rule required by Rule 204-2(a)(16) prior to registration. The amended rule allowed the newly registered investment adviser to continue to use performance information for investment periods prior to its registration with the SEC even though it was not in compliance with (a)(16) during any such pre-registration periods. The ruling by the Court of Appeals may be deemed to have vacated the amendment to Rule 204-2 thereby potentially disadvantaging such investment advisers and restricting their use of performance information even though they were previously enabled to use such information. The SEC answered the ABA letter by clarifying that it would not recommend enforcement action under Section 204 or Rule 204-2(a)(16) of the Advisers Act if an investment adviser that registered as a result of the SEC's adoption of Rule 203(b)(3)-2 does not maintain or preserve the books and records required by Rule 204-2(a)(16), provided the investment adviser satisfies the terms and conditions of the vacated Rule 204-2(e)(3)(ii). This clarification provided meaningful comfort to registered investment advisers caught in the gap between performance inclusion and exclusion prior to registration by not disrupting their prior performance practices, which could have been materially detrimental to their marketing efforts.

The SEC also addressed in its response the issue of performance-based compensation arrangements of registered investment advisers who registered with the SEC as a result of the adoption of Rule 203(b)(3)-2. In its response letter to the ABA, the SEC noted that Section 205(a)(1) prohibits investment advisers from receiving compensation ''on the basis of a share of a client's capital gain or appreciation'' but that Rule 205-3 provides an exemption from such prohibition with regard to persons who qualify as ''qualified clients'' as defined in the rule. The SEC had amended Rule 205-3 to add new paragraphs (c)(2) and (3) which permitted investment advisers who had registered with the SEC as a result of the adoption of Rule 203(b)(3)-2 to continue to receive performance-based compensation from their investors and clients who did not qualify as ''qualified clients'' if those persons became investors or clients prior to February 10, 2005. As noted in the response letter, without the amended paragraphs in effect, investment advisers who are newly registered with the SEC could be required to terminate fee arrangements and advisory contracts that provided for performance-based compensation. The SEC answered the ABA letter by clarifying that it would not recommend enforcement action under Section 205(a)(1) against an SEC-registered hedge fund investment adviser that receives performance-based compensation if and to the extent that the investment adviser would have been exempt from the restriction on receiving such compensation under the vacated Rule 205-3(c)(2) or (3).

Additionally, the SEC addressed in its response certain issues surrounding Rule 206(4)-2 which details the procedures required by registered investment advisers with custody of client funds or securities including the requirements for the provision of quarterly account statements to advisory clients, the annual verification of all client funds and securities by an independent accountant if account statements are provided by the investment adviser, and the distribution of such account statements to all limited partners or investors in a pooled investment vehicle. The exception to the rule for pooled investment vehicles is applicable if the pooled vehicle is audited on an annual basis in accordance with generally accepted accounting principles and such audited financials are distributed to the vehicle's investors within 120 days of the end of the vehicle's fiscal year. This rule was amended to extend the 120-day deadline to 180 days for funds-of-funds based on the rationale that the preparation of audited financials for a fund-of-funds is subject to obtaining the underlying financials for the fund-of-funds' underlying portfolio funds, which may require additional time. In the post-Goldstein period, without such amendment in effect, the audited financial statement delivery requirement would revert to 120 days, potentially creating difficulties for many funds-of-funds to meet such requirements. The SEC addressed this issue in its response by clarifying that it would not recommend enforcement action under Section 206(4) or Rule 206(4)-2 against an investment adviser to a fund-of-funds relying on the annual audit exception of Rule 206(4)-2 if the audited financial statements of such fund-of-funds are distributed to investors in the fund-of-funds within 180 days of the end of the fund-of-fund's fiscal year.

While the SEC has provided meaningful clarification as a stop-gap measure to many issues directly impacted as a result of the Goldstein decision, it is uncertain what further action will be taken by the SEC or legislatures to address numerous other issues directly raised by the Goldstein decision as well as issues created as a result of investment advisers who registered in reliance on the newly vacated Advisers Act rules. New rules and guidance relating to the applicability of the antifraud provisions of the Advisers Act in light of the Goldstein ruling may be next at bat. Investment adviser accreditation threshold for ''accredited investors'' may be ripe for modification by increasing such standards above the \$1 million net worth test for individuals. Similarly, liberalization of the manner of offering restrictions related to general solicitation and advertising may be within target range for change as well. The SEC's Advisory Committee on Smaller Public Companies in April 2006 recommended increasing the financial tests for an individual by calling for the implementation of an income or net worth test similar to the accredited investor thresholds set forth in Regulation D (e.g., \$2 million in joint net worth (from \$1 million) or \$300,000 in annual income or \$400,000 in joint annual income (from \$200,000 and \$300,000 jointly respectively). Further, the SEC questioned in the ''Implications of the Growth of Hedge Funds'' the necessity for general solicitation restrictions in connection with the offering of interests in funds relying on Section 3(c)(7) of the Investment Company Act of 1940 where all investors in the fund constituted ''qualified purchasers.'' By providing sufficient latitude to such general solicitation practices, capital formation could be promoted without materially risking investor protection.

While Goldstein may have prompted the future need for legislative action and further SEC rulemaking, the SEC has been quick to lay a temporary board over a deep chasm created by the decision. As the investment adviser regulatory framework reshifts in the wake of the decision to accommodate the day-to-day practical needs of the hedge fund industry, the need for greater regulatory clarity becomes important.

Notes

1. Goldstein v. Sec. and Exch. Comm'n, NO. 04-1434 (D.C. Cir. June 23, 2006).
2. Investment Advisers Act Release No. 2333 (December 2, 2004).
3. H.R. 5712 (introduced 6/29/2006).
4. H.R. 6079 (introduced 9/14/2006).