

**U.S. COURT OF APPEALS OVERTURNS HEDGE FUND
ADVISER REGISTRATION RULE**

The United States Court of Appeals for the District of Columbia Circuit today invalidated a controversial Securities and Exchange Commission rule that was designed to subject most hedge fund advisers to the substantive rules of the Investment Advisers Act of 1940. The unanimous opinion in *Goldstein v. U.S. Securities and Exchange Commission* held that the rule is arbitrary and that the SEC's interpretive position underlying the rule "bears no rational relationship to achieving [the policy] goal[s] [of the Advisers Act]." The Court vacated and remanded the rule to the SEC.

The Advisers Act exempts advisers from registration if they meet certain requirements, including having not more than 14 clients in any twelve-month period. For many years under SEC rules, a hedge fund and not its underlying investors was considered the "client" for purposes of determining whether the adviser could avail itself of the 14 or fewer exemption.¹

Effective February 1, 2006, the SEC adopted a new rule that required advisers to certain privately offered investment funds to register under the Advisers Act. That rule reversed the SEC's traditional client counting policy and provided that an investment adviser must "look through" any "private fund" to count the fund's investors as clients.

The Advisers Act does not define "client." The Court took issue with the SEC's assertion that the lack of a definition means that the statute is ambiguous with respect to a particular term. As the Court said, there is no such rule of law. The Court also said that the SEC's interpretation of the term "client" comes close to violating the plain language of the statute.

SEC Chairman Christopher Cox issued a statement today that the Court's finding requires the Commission to reevaluate its approach to hedge fund activity and that the SEC staff has been instructed to provide the Commission with a set of alternatives. Chairman Cox also said that the SEC would continue to work with other federal regulators, including the Commodity Futures Trading Commission, to evaluate the systemic market risks and other issues associated with hedge funds.

As a consequence of the Court's ruling, hedge fund advisers that recently registered under the Advisers Act pursuant to the now vacated rule may wish to consider withdrawing their registration. While any investment adviser, whether or not registered, is subject to the Advisers Act's anti-fraud provisions, de-registration would relieve an adviser from adherence to most of the provisions of the Advisers Act and the rules promulgated thereunder. Unregistered advisers also are not subject to regular SEC inspections.

¹ See former SEC Rule 203(b)(3)-1 under the Advisers Act.

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