SEC Chairman Cox Testifies on Hedge Fund Manager Registration

Today, SEC Chairman Cox testified before the Senate Banking Committee concerning the regulation of hedge funds. As part of his testimony, Chairman Cox addressed the steps being taken by the SEC in response to the D.C. Court of Appeals’ decision to overturn the hedge fund manager registration rule. These steps, which will be taken as a result of the SEC’s apparent decision not to appeal the court’s decision, are summarized below. A full copy of Chairman Cox’s testimony can be found at http://www.sec.gov/news/testimony/2006/ts072506cc.htm.

New Anti-fraud Rule

Chairman Cox will recommend that the SEC adopt a new anti-fraud rule under the Advisers Act that will have the effect of “looking through” a hedge fund to its investors. This step is intended to address language in the court’s opinion stating that a hedge fund adviser owes a fiduciary duty only to the fund itself, but not to the fund’s investors.

Restoration of Certain Transitional and Exemptive Rules

When the SEC adopted the rule and rule amendments in 2004 to require most hedge fund managers to register under the Advisers Act, the SEC simultaneously adopted several related transitional and exemptive rules designed to facilitate those registrations and clarify certain rules under the Advisers Act. The court’s decision, which may have been imprecisely drafted, arguably had the effect of also overturning those transitional and exemptive rules. Chairman Cox has directed the SEC staff to take emergency action to restore the full legal effect of those rules, which included:

- A grandfather provision permitting newly registered hedge fund managers to continue charging a performance fee to investors and other advisory clients who were investors or clients of the manager prior to February 10, 2005. (See Rule 205-3(c)(3))
• A grandfather provision permitting newly registered hedge fund managers to present their past performance information for periods prior to February 10, 2005 even when the managers do not otherwise have all of the required supporting records. (See Rule 204-2(e)(3)(ii))

• A provision in the Custody Rule that permits hedge fund managers to comply with the delivery of audited accounts statements within 180 days of the end of a fund of funds’ fiscal year, rather than within 120 days as is the case for other types of hedge funds. (See Rule 206(4)-2(b)(3).)

• A provision in the hedge fund manager registration rules that specifically permits an offshore manager to treat a hedge fund organized or incorporated outside the United States as its client for most purposes under the Advisers Act (which formed the basis for “registration lite”). (See Rule 203(b)(3)-2(c))

Amendments to the “Accredited Investor” Standard

Chairman Cox has asked the SEC staff to analyze and report to the SEC on the possibility of amending the current definition of “accredited investor” as applied to retail investment in hedge funds without registration. In making this recommendation, Chairman Cox observed that hedge fund manager registration would have had the effect of raising the minimum investment standard to $1.5 million net worth, rather than $1 million, based on the requirements of Rule 205-3 which addresses the ability of registered advisers to charge performance fees.

Additional Steps

Chairman Cox observed that hedge fund managers – whether registered or not – remain subject to SEC regulation under the antifraud, civil liability and other provision of the federal securities laws. He stated that the SEC will continue to bring enforcement actions against hedge fund managers who violated those laws.

Finally, Chairman Cox testified that he has directed the SEC staff to continue conducting compliance examinations of investment advisers who remain registered with the SEC, or who register in the future.

Industry Reassurance

Notwithstanding the steps outlined by Chairman Cox and his expressed view that the SEC’s current program of hedge fund regulation is inadequate, he sought to reassure the hedge fund industry. Specifically, Chairman Cox stated that “there should be no interference with the investment strategies or
operations of hedge funds, including their use of derivatives trading, leverage, and short selling.” He also expressed the view that regulations should not require the disclosure of a fund’s portfolio composition or trading strategies, and that hedge fund managers should be able to continue to charge their clients performance fees.

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If you have any questions about this memorandum or want to discuss in more detail the Chairman’s testimony, please call Terrance O’Malley at (212) 859-8402 or Jessica Forbes at (212) 859-8558, or any of the other partners in the Fried Frank Asset Management Group.

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