Hedge Funds: *Goldstein v. Securities and Exchange Commission*

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July 31, 2007

Congressional Research Service
7-....
www.crs.gov
RS22528

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

In 2004 the Securities and Exchange Commission (SEC) issued a rule which resulted in requiring many hedge fund advisers to register as investment advisers under the Investment Advisers Act. Because hedge fund advisers had for the most part before the rule been exempt from registration so long as they had fewer than 15 clients, hedge fund advisers, referred to collectively as Goldstein, brought suit to challenge the rule. The District of Columbia Circuit, after examining an amendment to the Investment Advisers Act, previous statements by the Securities and Exchange Commission, and the Supreme Court case *Lowe v. Securities and Exchange Commission*, in a three-judge panel unanimously held that the SEC's hedge fund rule was arbitrary and vacated and remanded the rule. On August 7, 2006, Chairman Cox stated that the SEC would not seek en banc review of the Court of Appeals decision and would not petition the United States Supreme Court for a writ of certiorari. In response to the *Goldstein* decision, the SEC on December 13, 2006, voted unanimously to issue a proposal for a new antifraud rule under section 206(4) of the Investment Advisers Act that would prohibit an investment adviser from defrauding investors in a hedge fund or certain other pooled instruments. On July 11, 2007, the SEC voted unanimously to approve new Rule 206(4)-8 to state the commission's authority to pursue fraudulent misconduct by hedge fund advisers. The rule was adopted in the wake of *Goldstein* in order to clarify the commission's authority in this area. There is also congressional interest in regulating hedge funds. This report will be updated as necessary.

The term "hedge fund" is difficult to define, since it does not appear anywhere in federal securities laws. No single definition of the term appears to be used by industry participants, but perhaps one of the most useful definitions of a hedge fund is that it is "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[1]

Hedge funds have received a great deal of media coverage in the past several years because large sums of money have been gained or lost in a relatively short time by some hedge funds. Some members of Congress believe that the SEC should be given specific statutory authority to require the registration of hedge funds or their advisers.[2] Arguments for other kinds of regulation or for no regulation have also been urged.[3]

In 2004 the SEC issued a rule[4] which resulted in requiring many hedge fund advisers to register with the SEC as investment advisers[5] under the Investment Advisers Act.[6] The hedge fund rule first defines a "private fund" as an investment company that is exempt from registration under the Investment Company Act[7] because it has fewer than one hundred investors or only qualified investors,[8] allows its investors to redeem their interests within two years of investing, and markets

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[1] President's Working Group on Financial Markets, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999). Another useful definition of the term is an "entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act." United States Securities and Exchange Commission, STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION ON THE IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 3 (2003).

[2] *See, e.g.*, H.R. 5712, 109th Cong.

[3] *See* CRS Report 94-511, *Hedge Funds: Should They Be Regulated?*, by (name redacted).

[4] 69 FED. REG. 72,054 (December 10, 2004), *codified at* 17 C.F.R. Parts 275 and 279.

[5] An investment adviser is defined 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, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 [12 U.S.C.A. § 1841 et seq.] which is not an investment company, except that the term "investment adviser" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, and not the bank itself, shall be deemed to be the investment adviser; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934 [15 U.S.C.A. § 789c)(12)], as exempted securities for the purposes of that Act [15 U.S.C.A. § 78a et seq.]; or (F) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order. 15 U.S.C. § 80b-2(11).

[6] 15 U.S.C. §§ 80b-1 *et seq*.

[7] 15 U.S.C. §§ 80a *et seq*.

[8] 15 U.S.C. § 80a-3(c)(1), (7).

itself based upon the "skills, ability, or expertise of the investment adviser."[9] The rule goes on to state that these private funds, "[f]or purposes of section 203(b)(3) of the [Investment Advisers] Act (15 U.S.C. § 80b-3(b)(3)),...must count as clients the shareholders, limited partners, members, or beneficiaries...of [the] Fund."[10] Because hedge fund advisers had for the most part before the rule been exempt from registration so long as they had "fewer than fifteen clients,"[11] hedge fund advisers, referred to collectively as "Goldstein," brought suit to challenge the equation under the rule of "client" with "investor."

Goldstein argued that the SEC misinterpreted section 203 of the Investment Advisers Act, which exempts from registration "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients...."[12] In response to Goldstein's argument, the SEC argued that, because the Investment Advisers Act does not define "client," the term is therefore ambiguous. The SEC in its argument for authority to issue the hedge fund rule relied upon the discussion in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council*[13] that "[i]f...the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, [footnote omitted] as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute [footnote omitted]."[14] The SEC argued in *Goldstein* that, because the Investment Advisers Act does not define "client," it was a "permissible construction of the statute" for it to issue the hedge fund rule equating "client" with "investor."

The District of Columbia Circuit in a three-judge panel unanimously found that this argument with respect to the SEC's hedge fund rule did not mesh with an amendment by Congress to section 203 and that it was counter to interpretations that the SEC itself had made over the years about hedge fund advisers and investors.[15]

According to the court, a 1970 amendment, in which Congress eliminated a separate exemption from registration under the Investment Advisers Act for advisers who advised only investment companies and explicitly made the fewer than 15 clients exemption unavailable to such advisers,[16] would have been unnecessary if the shareholders of investment companies could be counted as "clients." The court went on to state that another section of the Investment Advisers Act suggests that Congress did not intend "shareholders, limited partners, members, or beneficiaries" of a hedge fund to be considered clients. In its definition of 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,"[17] the Investment Advisers Act does not cover a hedge fund

[9] 17 C.F.R. § 275.203(b)(3)-1(d)(1).

[10] 17 C.F.R. § 275.203(b)(3)-2(a).

[11] Exempted from registration is "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company...." 15 U.S.C. § 80b-3(b)(3).

[12] 15 U.S.C. § 80b-3(b)(3).

[13] 467 U.S. 837, 842-843 (1984).

[14] *Id.* at 843.

[15] *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006).

[16] P.L. 91-547, § 24, 84 Stat. 1413, 1430 (1970).

[17] 15 U.S.C. § 80b-2(11).

manager whose job is to control the disposition of the pool of money in the fund and not to give investment advice. If, according to the court, the person controlling the fund is not an investment adviser to each individual investor, each investor cannot be a client of that person.

The SEC itself, before issuing the hedge fund rule, had apparently argued that an investment adviser of an entity like a hedge fund does not directly advise others. In 1997 the SEC stated that a "client of an investment adviser typically is provided with individualized advice that is based on the client's financial situation and investment objectives. In contrast, the investment adviser of an investment company need not consider the individual needs of the company's shareholders when making investment decisions, and thus has no obligation to ensure that each security purchased for the company's portfolio is an appropriate investment for each shareholder."[18]

The court then discussed a United States Supreme Court case to buttress further its position. The case, *Lowe v. Securities and Exchange Commission*,[19] held that certain financial newsletters were not investment advisers. After looking at the legislative history of the Investment Advisers Act, the Court held that the existence of an advisory relationship depended primarily upon the character of the advice given. An investment adviser "provide[s] personalized advice attuned to a client's concerns."[20] According to the court in *Goldstein*, the adviser/manager of a hedge fund is concerned with the fund's performance and not with the financial condition of each investor.

The District of Columbia Circuit concluded that "[t]he Commission has, in short, not adequately explained how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter"[21] and held that the SEC's hedge fund rule was arbitrary and vacated and remanded the rule.

On August 6, 2006, Chairman Cox stated that the SEC would not seek en banc review of the Court of Appeals decision and would not petition the United States Supreme Court for a writ of certiorari.

On December 13, 2006, the SEC voted unanimously to issue a proposal for a new antifraud rule under section 206(4)[22] that would prohibit an investment adviser from defrauding investors in a hedge fund or certain other pooled investments. According to Chairman Cox, this proposal by the SEC responds to the *Goldstein* decision.[23]

On July 11, 2007, the SEC unanimously voted to approve new Rule 206(4)-8 under section 206 of the Investment Advisers Act.[24] The rule, passed in the wake of *Goldstein*, would clarify the Commission's authority to pursue fraudulent misconduct by hedge fund advisers. Only the government under this rule, not private litigants, will have the right to sue to enforce the rule.

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[18] *Status of Investment Advisory Programs Under the Investment Company Act of 1940*, 62 FED. REG. 15,098, 15,102 (March 31, 1997).

[19] 472 U.S. 181 (1985).

[20] *Id.* at 208.

[21] *Goldstein*, at 882.

[22] 15 U.S.C. § 80b-6(4).

[23] DAILY REPORT FOR EXECUTIVES (BNA), A-41 (December 14, 2006).

[24] SEC Press Release 2007-133, http://www.sec.gov/news/press/2007/2007-133.htm.

There is also congressional interest in the area. For example, S. 1402, 110th Congress, would amend the Investment Advisers Act to limit the exemption from registration by an investment adviser. Another example of congressional interest is the desire by some to require hedge funds to retain certain data and documents for SEC enforcement purposes.[25]

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[25] DAILY REPORT FOR EXECUTIVES, No. 133, at A-21 (July 12, 2007).