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# SEC to Propose Emergency Rules to Deal with *Goldstein v. SEC*

July 26, 2006

In July 25, 2006 testimony before the Senate Committee on Banking, Housing and Urban Affairs,[1] Christopher Cox, Chairman of the Securities and Exchange Commission (SEC), identified six areas for emergency rule-making when the Court issues its mandate in mid-August in *Goldstein v. SEC* vacating the SEC's hedge fund adviser registration rules under the Investment Advisers Act of 1940, as amended (Advisers Act). The actions identified are:

1. The SEC will issue a new anti-fraud rule under the Advisers Act that would look through a hedge fund to its investors and clarify the duty of a hedge fund adviser to the investors in a fund;
2. Continue the exemption from the prohibition on taking performance fees from investors in a domestic hedge fund who are not "qualified clients" that invested prior to February 10, 2005;
3. Continue the exemption for newly registered hedge fund advisers from the requirement for the adviser to have and keep records supporting performance claims with respect to their performance prior to February 10, 2005;
4. Continue the custody rule exception to allow fund of hedge fund advisers 180 days from the end of their fiscal year to deliver audited financial statements to their investors;
5. Continue the "Regulation Lite" regime for foreign advisers to foreign based hedge funds with U. S. investors who register under Advisers Act; and
6. Amend the definition of "accredited investor" to raise the net worth test for an individual investor and spouse from $1 million to $1.5 million.

Chairman Cox stated that he had directed the SEC's examination staff to continue their compliance examination of SEC registered advisers to hedge funds, and will recommend that the SEC further limit the marketing and availability of hedge funds to unsophisticated retail investors and to consider what other steps the SEC should take regarding hedge fund advisers. He further stated that the SEC is going back to the drawing boards to devise a workable means of acquiring basic census data to monitor hedge fund activity in a way to mitigate systemic risk.

These remarks clearly imply that the SEC will not appeal the Goldstein decision. Chairman Cox emphasized that, notwithstanding the Goldstein decision, hedge funds remain subject to SEC regulation and enforcement under the anti-fraud provisions of the federal securities laws.

He stated that the Committee could consider legislation, and the SEC would provide technical advice and assistance if requested. However, Chairman Cox did not urge a legislative response to the Goldstein decision or the regulation of advisers to hedge funds. He urged that any future legislation or regulation not interfere with investment strategies or operations of hedge funds, including use of derivatives, leverage or short selling or take other action that would stifle their creativity, liquidity or flexibility. He also stated that there should be no portfolio disclosure requirements.

Commentators have indicated that the Senate Committee is concerned with the relative lack of regulation of hedge funds, but is expected to give the SEC a window of opportunity to deal with the Court's vacation of the SEC hedge fund adviser registration rules before acting legislatively.

[1] http://www.sec.gov/news/testimony/2006/ts072506cc.htm

## We Can Help

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