

# HENDERSON & LYMAN

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## CLIENT ADVISORY

HENDERSON & LYMAN FINANCIAL SERVICES DIVISION - JUNE 27, 2006

### **D.C. Court of Appeals vacates and remands Hedge Fund Rule**

On June 23, 2006, the United States Court of Appeals for the District of Columbia Circuit vacated and remanded Rule 203(b)(3) and the related amendments to existing rules (collectively, the "Hedge Fund Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"). The Hedge Fund Rule affects how managers or advisers to "private investment" funds are required to count their clients for purposes of the Advisers Act. In its opinion, the Court found that the Hedge Fund Rule is arbitrary. The Court stated that the SEC's interpretation of the term "client" "falls outside the bounds of reasonableness" and "comes close to violating the plain language of the statute."

Prior to adopting the Hedge Fund Rule, the SEC interpreted the term "client" to permit managers, advisers and/or general partners of "private investment" funds to count only the fund as a client, not the investors in those funds in determining whether managers were exempt from the definition of an "investment adviser" under the Advisers Act because they had fewer than 15 clients. As a result of the Hedge Fund Rule, managers and/or advisers of private funds are required to look through the funds they manage and/or advise and count the fund's underlying investors as clients for purposes both of the 14-client threshold and to determine whether the manager must register as an investment adviser with the SEC.

In response to the ruling, the SEC released a statement from Chairman Christopher Cox on June 23, 2006, instructing the SEC's staff to evaluate the court's decision and to provide a set of alternatives for the SEC's consideration.

While we cannot predict how the SEC will react in regards to regulating the hedge fund industry in light of the decision, it seems premature to anticipate that the SEC will end its efforts to broaden the regulatory scope of the Adviser's Act as a result of this decision. Since the Hedge Fund Rule is invalid and unenforceable as a result of the Court's ruling, the Hedge Fund Rule cannot reliably be used as a guide for likely future regulatory requirements. Consequently, we cannot recommend continued reliance on the regulatory framework and safe harbors established by the Hedge Fund Rule. Unfortunately this creates significant uncertainty.

Because of this uncertainty, we are generally advising clients who previously registered with the SEC as investment advisers to not take steps to de-register prematurely until we have a better sense of how the SEC will respond to this decision. Moreover, some fund managers, advisers and/or general partners that adopted a two year lock-up to avoid registration in response to the Hedge Fund Rule may, for business reasons, want to consider eliminating this restriction unless and until the SEC publishes a new rule proposal, or at the very least, gives an indication of how it is likely to regulate hedge funds and their managers and advisers on a going forward basis.

Finally, we note that while this decision may eventually impact the regulatory efforts of state regulators, this decision does not alter or reduce the state registration requirements to which fund managers, advisers and/or general partners of hedge funds and other private funds were or are otherwise subject, separate and aside from the Hedge Fund Rule.

Please contact us if you would like additional information about the decision and its impact on the operation of your business.