Hedge funds have proliferated dramatically in the past several years. Once viewed as an investment available exclusively to the wealthy, recent studies estimate that there are now more than 8,000 funds in the United States with at least $1.5 trillion in assets under management. This impressive growth has made hedge funds as controversial among regulatory agencies as they are popular among investors. The Securities and Exchange Commission (SEC) – having tried and failed in 2006 to require registration of virtually all of the managers of hedge funds – is now primed to regulate hedge funds through an enforcement initiative that agency officials plainly voice as a top priority in 2008.

To facilitate this initiative, the SEC penned new rule-making last year that expands its scope of authority over all hedge fund managers, regardless of whether they are registered. The agency also formed a special working group that focuses on investigating and eliminating perceived illegalities among hedge funds. This working group is designed both to conduct its own investigations and coordinate with other enforcement bodies, including, most notably, the United States Attorney’s Office, which has demonstrated a recent proclivity for pursuing parallel criminal proceedings against securities professionals.

In Goldstein v. SEC, decided in June 2006, the United States Court of Appeals for the District of Columbia Circuit vacated SEC Rule 203(b)(3)-2 under the Investment Advisers Act of 1940, which required most hedge fund advisers with $30 million or more in assets under management and 15 or more clients to file a Form ADV and register with the SEC. Under this rule, registered hedge fund advisers would have been required to adopt written compliance policies and procedures, maintain certain books and records, designate a compliance officer, accept performance fee restrictions, and consent to audits and inspections by the SEC.

In vacating Rule 203(b)(3)-2, the Court of Appeals specifically rejected the SEC’s proposed methodology for counting “clients” – a term undefined under the Advisers Act. Under this rule, when determining whether hedge fund advisers had exceeded the fifteen client threshold for registration, the agency required fund advisers to “look through” their hedge funds and count all of the “shareholders, limited partners, members or beneficiaries” as clients, rather than simply counting the hedge funds that they managed. The appellate court found this arbitrary since, in prior releases, the SEC had interpreted investment pools and limited partnerships as single clients, rather than applying the now-favored “look through” approach.

Despite its legal setback, the SEC’s efforts to regulate the hedge fund industry were far from a complete failure. Hedge fund managers with $30 million or more in assets under management and 15 or more clients as calculated under Goldstein – remain obligated to register. Certain managers that registered and had the option to deregister chose not to do so for a variety of
reasons, including a belief that registration lends credibility to the fund manager. In May 2007, 51 of the largest 100 hedge fund managers (based on assets under management) were registered with the SEC and, in August 2007, over 3,000 of the 10,705 registered investment advisers – about 30% – reported hedge funds among their existing clients. Accordingly, even post-Goldstein, much of the hedge fund industry is regulated by the SEC.

The Founding of a Hedge Fund Working Group

In January 2007, Senators Arlen Spector, R - Pa., and Charles Grassley, R - Iowa, representing the Senate Judiciary and Finance Committees, respectively, delivered an interim report that was sharply critical of the SEC’s handling of an insider trading investigation involving hedge fund manager, Pequot Capital Management. In a lengthy final report issued in August, the two committees pointed to “real failures” in the SEC’s ability to handle “complex” securities investigations. The report recommended that the SEC take particularized remedial measures to ensure that matters involving complicated issues are “handled as uniformly as possible throughout the Enforcement Division.”

In response to this public admonishment, SEC Chairman Christopher Cox announced in July 2007 that the SEC had established a Hedge Fund Working Group (HFWG). As explained, the HFWG would include a core team of attorneys, investigators and examiners in each SEC office assigned to “coordinate and enhance [the agency’s] efforts to combat hedge fund insider trading” and other illegalities that arise in the hedge fund industry. In addition, Chairman Cox noted that the SEC designed the HFWG to assist and coordinate with other federal law enforcement agencies and self-regulatory organizations, including the United States Attorney’s Office, the Financial Industry Regulatory Authority, the New York Stock Exchange and the Commodity Futures Trading Commission. As of November 2007, the HFWG had reportedly grown to approximately 100 SEC professionals nationwide.

An Opening Round of Formal Inquiries

The SEC’s Office of Compliance, Inspections and Examinations issued comprehensive inquiry letters in August 2007 to 27 registered hedge fund advisers. Bruce Karpati, Assistant Regional Director of Enforcement in the New York Regional Office, who coordinates the HFWG nationally, revealed that these letters were designed to discover the identities of the funds’ “strategic investors” and assess the risks of “the misuse of information” originating from public companies or financial services firms that invest in hedge funds. These selected funds were also requested to produce copies of their ethics codes and insider trading policies governing all fund personnel, including contract and temporary employees. The letters further requested:

- Lists of all persons who invested in the hedge fund;
- Lists of all “access persons” (i.e., fund personnel with access to its trading, research or account information) required to report personal securities transactions;
- Copies of all policies designed to monitor the personal trading activities of “access persons”;
- Lists of all corporate insiders, hedge fund executives or brokerage executives who have invested in any of the adviser’s private investment funds, together with each of these investor’s subscription agreements;
- Copies of all policies and procedures involving watch lists and restricted lists;
- Copies of all policies concerning the receipt of gifts and entertainment;
- Copies of all logs recording any gifts or entertainment provided to fund personnel; and
- Information regarding all one-on-one meetings that fund personnel attended at all broker-sponsored conferences.

Chairman Cox viewed these letters in September 2007 as a “pilot” program. He predicted publicly that if “things go well, [the hedge fund industry] should expect more” inquiry letters in the foreseeable future.

The Unveiling of a New “Antifraud” Rule

In August 2007, the SEC issued a new rule – Advisers Act Rule 206(4)-8 – to “clarify” its statutory authority to pursue fraudulent wrongdoing post-Goldstein against hedge fund advisers, as well as private equity funds, venture capital funds and mutual funds. Ef-
fective September 2007 and enforceable against both registered and unregistered advisers, Rule 206(4)-8 states, in pertinent part:

It shall constitute a fraudulent, deceptive, or manipulative act, practice or course of business ... for any investment adviser to a pooled investment vehicle to:

(a) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or

(b) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

In the Adopting Release issued with this new rule, the SEC elaborated on how it envisioned its application. According to this release, hedge fund advisers could potentially violate Rule 206(4)-8 through statements to investors or prospective investors regarding current or future investment strategies; credentials and experience of fund personnel; fund performance and valuation; and the performance or valuation for any investor account. Moreover, as drafted, this rule applies not only to statements made to existing investors, but also those made to prospective investors, whether through private placement memoranda, offering circulars, investment presentations and proposals, due diligence questionnaires or electronic solicitations.

While the SEC presented this as an “antifraud” rule and proclaimed it “almost identical” to other antifraud regulations, Rule 206(4)-8 notably lacks a scienter requirement. Accordingly, unlike other antifraud provisions, a hedge fund adviser could be found liable without a demonstration of either an intentional act or reckless behavior. Indeed, in the Adopting Release, the SEC underscored its viewpoint, stating:

Commenters questioned whether the rule should encompass negligent conduct, arguing that it would ‘expand the concept of fraud beyond its original meaning’ .... We believe use of a negligence standard also is appropriate as a method reasonably designed to prevent fraud .... We believe that, by taking sufficient care to avoid negligent conduct, advisers will be more likely to avoid reckless deception. Since the SEC clearly is authorized to prescribe conduct that goes beyond fraud as a means reasonably designed to prevent fraud, prohibiting deceptive conduct done negligently is a way to accomplish this objective.

Responding in December 2007 to those who criticized the novel concept of “negligence-based fraud,” Walter Ricciardi, the Deputy Director of the Enforcement Division, reaffirmed the SEC’s position. He also revealed that, while SEC investigations would “focus on scienter fraud,” settlements of violations under this new rule would not necessarily include a finding of scienter.

Rule 206(4)-8 differs from other antifraud rules in two other key respects. First, unlike its counterpart, Rule 10b-5 under Section 10(b) of the Securities Exchange Act of 1934, a violation of this rule does not need to occur “in connection with” the purchase or sale of a security. Additionally, it would encompass account statements and other reports issued to investors during periods when the fund is not offering, selling or redeeming securities. The rule is also noteworthy in that it provides no private right of action, meaning that it is enforceable by the government, but not available to any private plaintiff in shareholder litigation.

**Expected SEC Enforcement Initiatives**

The SEC became particularly vocal during the fourth quarter of 2007 about its ongoing hedge fund enforcement activities. Scott Friestad, Associate Director of the Enforcement Division, announced in November that the HFWG’s nationwide force was focusing principally on two types of cases – trading abuse cases and fraud cases. He defined “trade abuse cases” to include insider trading, Private Investment in Public Equity (PIPE) misusages and cases involving improper short sales under Regulation M. By comparison, Friestad associated “fraud cases” with false asset valuations and disclosures designed to conceal fund losses resulting from defective trading strategies. In December, Assistant Regional Director Karpati revealed that the HFWG was also pursuing matters involving purportedly improper soft dollar relationships and in-
vestment allocations. Matters such as these have been classified as “conflict of interest” cases by Chairman Cox and others.

**Conclusion**

In summary, 2008 promises to be an attention-grabbing year as the Commission continues its efforts to regulate the hedge fund industry – if not formally, then through a well-coordinated series of enforcement initiatives designed to extend its authority far beyond its historical scope. While many of the underlying legal issues discussed above will take far greater than a single year to resolve, we should expect some initial indications as to where the Commission’s authoritative boundaries ultimately will rest.

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For more information about the matters discussed in this Alert, please contact your regular Drinker Biddle lawyer or any member of our Hedge Funds Task Force.

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In our next Alert... We examine in detail the most recent SEC enforcement actions waged against hedge funds involving so-called “trade abuses.”