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A Client Alert from Paul Hastings

SEC Will Not Appeal Hedge Fund Ruling

From the Investment Management Practice Group

On August 7, 2006, SEC Chairman Christopher Cox announced¹ that the SEC will not appeal the D.C. Circuit Court of Appeals' decision in *Goldstein v. SEC*, the decision which invalidated the SEC's hedge fund adviser registration rules. Chairman Cox stated that, since the appellate court's decision was based on multiple grounds and was unanimous, "further appeal would be futile and would simply delay and distract from the goal of advancing investor protection." Instead, Chairman Cox confirmed that the SEC will move aggressively on an agenda of rulemaking and staff guidance to address the legal consequences from the invalidation of the rules.

Chairman Cox indicated that the new rulemaking and staff guidance could commence as early as next week and will be similar to that he proposed in his July 25, 2006 testimony before the Senate Committee on Banking, Housing and Urban Affairs.² Specifically, Chairman Cox stated that the SEC can be expected to (i) promulgate a new anti-fraud rule under the Investment Advisers Act of 1940 (the "Advisers Act") that would have the effect of "looking through" a hedge fund to its investors, (ii) take emergency action to insure that the transitional and exemptive rules also invalidated by *Goldstein* are restored to full legal effect, so that hedge fund managers which were relying on those rules are not suddenly in violation of the SEC's regulatory requirements when the Court issues its final mandate in mid-August; and (iii) consider increasing the minimum asset and income requirements for individuals who invest in hedge funds.

The D.C. Court of Appeals previously issued an order delaying the date of effectiveness of its decision in *Goldstein* until seven days after the disposition of any timely petition by the SEC for rehearing or rehearing *en banc*. The SEC had until August 7, 2006 to file such a petition or, alternatively, to appeal the decision directly to the US Supreme Court by September 21, 2006. The SEC's decision yesterday not to petition for a rehearing or appeal the decision means that, effective August 14, 2006, the hedge fund adviser registration rules will no longer be in effect. At such time, hedge fund advisers that

recently registered with the SEC pursuant to the now vacated rules may wish to consider withdrawing their registration. Advisers who choose to de-register should consider the impact on existing investors, the need to disclose such de-registration to them and to amend fund documentation and the possible necessity of state investment adviser registration. Any decision to de-register should be made carefully and with full consideration of the ramifications. In view of the uncertainty created by *Goldstein's* invalidation of the transitional and exemptive rules and the possibility that pending legislation³ could effectively reverse *Goldstein*, the most prudent course of action might be to delay de-registration for a period of time until the SEC takes the emergency action promised by Chairman Cox and the prospects of that legislation become more certain.

NOTES:

¹Press Release No. 2006-135 (Aug. 7, 2006).

²See the PHJW Client Alert, SEC Chairman Seeks Emergency Rules for Hedge Funds (August 4, 2006).

³H.R. 5712, 109th Cong. (2006), Securities and Exchange Commission Authority Restoration Act of 2006 - Amends the Advisers Act, to authorize the SEC to treat shareholders, partners, and beneficial owners of, or investors in, clients of an investment adviser as "clients" for purposes of the Section 203(b)(3) registration exemption that is limited to advisers with 14 or fewer "clients." (Sponsor: Rep Barney Frank)

Paul Hastings' nationally recognized Investment Management Practice Group continues to be highly ranked among the top law firms by net assets of all mutual fund clients as reported by Lipper, a Reuters Company.

We will continue to monitor developments in this area. If you have any questions about this alert, or about investment management matters in general, please do not hesitate to contact any member of our Investment Management Practice Group.

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