SEC Declines to Appeal Goldstein: What Next for Hedge Funds?

As widely reported in the media, SEC Chairman Christopher Cox announced that the SEC would not seek further review of the Goldstein decision. Instead, the SEC is "moving aggressively" to address the legal consequences of the invalidation of the hedge fund adviser registration rules. Initiatives under consideration include increasing the minimum asset and income requirements for individual investing in hedge funds, and addressing the grandfathering, transition and other miscellaneous relief necessitated by the vacating of the rule.

Registered and unregistered hedge fund managers are reviewing what they should do next. Here are some issues to consider as the industry awaits additional SEC guidance, which could be issued as early as next week.

The Advantages of Delay. Chairman Cox's press release indicated that the SEC would provide guidance designed to enable managers who are already registered to "remain registered," and to "eliminate disincentives" for voluntary registration. One of the most anticipated aspects of the forthcoming SEC guidance is the concessions that will be made to prevent the widespread deregistration of hedge fund managers. Delaying deregistration until these concessions are identified might be a prudent course of action.

Deregistration and Reliance Rights. If remaining registered is not an attractive option (either before or after the issuance of further SEC guidance), deregistering managers should review their offering materials to determine whether investors purchased interests in their hedge funds relying on the fact that the manager was (or was about to become) a registered investment adviser. If they did so, managers should consider whether such investors should be given a special one-time opportunity to redeem their interests when the adviser deregisters, regardless of any lockups to which such investors are otherwise subject. It may be possible to mitigate this issue by delaying deregistration until the expiration of the lockup period applicable to most of the investors who purchased interests relying on the fact that the manager was or would be registered.

Shorten Lockups? Some managers avoided registration by imposing lockups of more than two years. In light of the invalidation of the registration rule, such managers should consider whether to amend their fund documents to shorten the applicable lockup periods to what they were prior to the promulgation of the registration rule, and whether such changes should apply to existing investors as well as to new investors. Resolution of this issue naturally involves a cost-benefit analysis between the marketing boost provided by shorter lockups and the operational stability provided by two year plus lockups.

Stiffer Qualification Requirements for Individual Investors. In addition to the commercial advantages of a longer lockup period, there may be a legal advantage to retaining a longer than two year lockup period. If the SEC increases the qualification requirements only for individual investors in hedge funds (defined to include private funds which permit their investors to withdraw a portion of their interest within two years of the purchase of such interest), leaving the lockup unchanged could enable the hedge fund to avoid the anticipated increased qualification requirements for individual investors. Resolution of this issue will turn on whether a significant portion of the target investors for a hedge fund would fail to meet the SEC's anticipated increased qualification requirements for individual investors.

Contact Information

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