



Risk Management Update July 2007

HEDGE FUND COMPLIANCE AND THE AFTERMATH OF GOLDSTEIN

As a result of Goldstein v. SEC, hedge fund managers are no longer required to register with the Securities and Exchange Commission (“SEC”). Yet, increasingly the SEC is focused on regulating and monitoring hedge fund activities. Consequently, the days of non-disclosure and minimal oversight for hedge funds are likely coming to a close.

It is prudent for hedge fund managers to begin taking steps to enhance their disclosure efforts. Hedge fund managers should proactively disclose any and all material information to their limited partners if they have not done so already. This includes, among other things, material information relating to conflicts of interest, soft dollar arrangements, affiliations, business continuity plans, anti-money laundering programs and valuation procedures. While these disclosures are not technically required at present, it is likely the SEC will mandate similar disclosure requirements pursuant to the anti-fraud provisions of the Securities Exchange Act of 1934.¹ Notably, even if regulators do not require these types of disclosures in the immediate future, pension consultants, institutions, and even individual investors are beginning to request this type of information during the request for proposal (“RFP”) and/or due diligence process.

To commence facilitating enhanced disclosures for hedge fund managers, the SEC has proposed two new rules. First, the new accredited investor rule would raise the bar for hedge fund investors by requiring all investors to meet certain worth requirements.² Under the proposal, all “natural persons” investing in hedge funds must be an accredited investor (as defined below)³ and have a minimum of \$2.5 million in investments.⁴ Those current investors who met the initial requirement are grandfathered but would not be eligible to make additional investments.

Secondly, the SEC has issued an Interpretive Release regarding the use of soft dollars and safe harbor provisions under §28(e) of the Securities and Exchange Act of 1934. This Release, dated July 24, 2006, extends its reach to hedge fund managers and the use of soft dollars by hedge fund managers.⁵ Under the proposal, the safe harbor would permit money managers to use client funds for certain soft dollar arrangements to secure research products and services which would not violate the fiduciary duty owed to hedge fund managers.

Hedge fund compliance continues to evolve after Goldstein. For now, hedge fund managers should remember that those who are registered with the SEC must comply with those provisions

¹ See 15 U.S.C. 78(10)(6).

² See proposed rules 509, 216. 17 C.F.R. 230, 275.

³ An accredited investor is defined as one either having a net worth of over \$1 million or an annual income of over \$200,000 individually or \$300,000 jointly; see 15.U.S.C. 78, Rule 501.

⁴ Does not include an investment held for investment purposes, real estate that is used by a natural person or certain family members for personal purposes or as a place of business, or in connection with a trade or business; see proposed rule 509(c)(1)(i).

⁵ See 17 C.F.R. 241, Footnote 25.

outlined in the Investment Adviser's Act of 1940. On the other hand, those funds who are unregistered must comply with the anti-fraud provisions of federal securities regulations. Consequently, regardless of registration status, hedge fund managers should actively focus on disclosures to its limited partners and investors to ensure they are providing material disclosures particularly in the midst of developing SEC initiatives.

For more information, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

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