



Regulatory Update — SEC Proposes Registration for Hedge Fund Advisers¹

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The Securities and Futures Market Regulation Group

SCHIFF HARDIN LLP

6600 Sears Tower
Chicago, Illinois 60606

t 312.258.5500
f 312.258.5600

1101 Connecticut Ave, N.W.
Suite 600
Washington, DC 20036

t 202.778.6400
f 202.778.6460

1230 Peachtree Street
18th Floor
Atlanta, Georgia 30309

t 404.806.3800
f 404.806.3801

www.schiffhardin.com

On July 14, 2004, a sharply divided Securities and Exchange Commission (“Commission”) voted to publish a proposal that would require investment advisers to hedge funds to register with the Commission under the Investment Advisers Act of 1940 (“Advisers Act”).² Proposed Advisers Act Rule 203(b)(3)-2 would require advisers to “private funds” to register with the Commission by requiring the advisers to “look through” the funds and to count the number of investors (rather than the fund) when determining whether the advisers are eligible for the private investment adviser exemption under the Advisers Act. While Chairman Donaldson and Commissioners Goldschmid and Campos voted in favor of publishing the proposal for comment, Commissioners Glassman and Atkins wrote an extensive dissent, stating that they could not support a proposing release that “papers over the weaknesses of the approach it puts forward, overstates the purported benefits, and ignores the possibility that viable, and indeed preferable, alternative approaches may exist.” The dissenters encourage commenters to respond not only to the issues discussed in the proposal, but also to those not raised. Comments on the proposal should be submitted to the Commission by September 15, 2004.

The Proposed Amendments

Section 203(b)(3) of the Advisers Act exempts from registration investment advisers with fewer than fifteen clients during the preceding twelve months that do not advise registered investment companies or business development companies, and that do not hold themselves out generally to the public as investment advisers. Current Rule 203(b)(3)-1 provides that a legal organization (such as partnership, trust or corporation) that receives investment advice based on its own objectives, rather than the individual investment objectives of its partners, beneficiaries or shareholders is considered to be a single client. As a result, for example, a general partner of a limited partnership as a collective investment vehicle for its limited partners has not had to register as an investment adviser under the Advisers Act regardless of the number of limited partners involved or the amount of assets in the partnership managed by that general partner, unless that general partner otherwise lost its ability to rely on Section 203(b)(3) (*e.g.*, by holding itself out generally to the public as an investment adviser).

According to the Commission, the growth in the hedge fund industry has permitted advisers to manage very considerable amounts of assets for hedge funds that have large numbers of investors without having to register as investment advisers under the Advisers Act, thereby

avoiding regulation and oversight by the Commission. In the Commission’s view, this is inconsistent with the underlying purpose of Section 203(b)(3), which the Commission characterizes as intended to exempt from registration only advisers with a very few clients drawn from family, friendship or similar relationships with the adviser. Stating that its administration of Section 203(b)(3) should be “informed” by Congress’ determination in 1996 to establish a threshold of \$25 million under management for federal interest in investment advisers, the Commission now believes that Rule 203(b)(3)-1 may provide too broad a safe harbor for certain investment advisers — namely, those who advise hedge funds with more than fourteen investors and that otherwise meet or surpass that threshold.

The SEC’s new rule, proposed Rule 203(b)(3)-2, would require investment advisers to count each owner (*i.e.*, each shareholder, limited partner, member or other security holder or beneficiary) of a “private fund” as a client for purposes of determining the availability of the private investment adviser exemption. A “private fund” would be defined as any company that: (i) would be an investment company but for the exceptions in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940;³ (ii) permits owners to redeem their ownership interests within two years of purchase; and (iii) is offered based on the investment advisory skills, ability or expertise of the investment adviser. If the proposed rule is adopted, an adviser to a “private fund” could no longer rely on the private adviser exemption if, during the course of the preceding twelve months, that fund had more than fourteen investors. In addition, advisers to hedge funds in which a registered investment company invests would have to count the investors in those registered funds as their own clients.⁴ Furthermore, hedge fund advisers located offshore would have to look through the funds that they manage, regardless of whether those funds are also located offshore, and count all investors that are U.S. residents as clients. Proposed Rule 203(b)(3)-2, however, contains an exception to the definition of “private fund” for a company that has its principal office and place and business outside the U.S., makes a public offering of the securities outside the U.S., and is regulated as a public investment company of the laws of a country other than the U.S.

The Commission also is proposing to adopt other measures that would limit the extraterritorial application of the Advisers Act that would otherwise occur as a result of its amendments, including amendments to its custody rules. In this regard, the Commission’s proposal would permit an offshore adviser to an offshore hedge fund to treat the fund, not its investors, as its client for all purposes

under the Advisers Act other than (i) determining the availability of the private adviser exemption and (ii) the provisions prohibiting fraud.

Because advisers that have not been registered likely would not have maintained the five years' worth of records of past performance that registered advisers are required to maintain pursuant to Advisers Act Rule 204-2, the Commission would provide a safe harbor from violation of that rule on a retroactive basis, but once a hedge fund adviser has registered, it would need to comply with the recordkeeping rule going forward. In addition, the Commission is proposing that the books and records of the registered hedge fund adviser also would include records of the private funds for which the adviser acts as general partner, managing member or in a similar capacity, because an adviser that is also the general partner of a private investment fund effectively controls all of the operations and assets of the hedge fund. This also would extend to any special purpose vehicle named as the hedge fund's general partner, as the proposed amendment also would cover private funds for which a related person of the adviser acts as general partner, managing member, or in a similar capacity. Notably, this amendment would give the Commission examination authority not only over hedge fund advisers, but over the hedge funds themselves.

One result of the proposed rule would be to restrict the ability of certain fund advisers to receive performance fees. Currently, Advisers Act Rule 205-3 permits an adviser to a fund exempt from registration under Section 3(c)(1) of the Investment Company Act to receive performance fees only if each investor in the fund is a "qualified client" – that is, the investor has a net worth of at least \$1.5 million or has at least \$750,000 of assets under management with the adviser. The Commission proposes to amend Rule 205-3 to avoid requiring certain hedge fund investors to divest their current interests in such funds as a result of not meeting the criteria for a "qualified client" under the current rule. Under the proposal, the Commission would allow the hedge fund's current investors who are not qualified clients to retain their existing investments in the fund and even to add to that account, but would prevent them from opening new accounts in that hedge fund or other hedge funds. Furthermore, hedge fund advisers would not have to change their fee arrangements with existing investors, but would have to comply with the new performance fee restrictions going forward.⁵

In addition, the Commission would amend Rule 206(4)-2, the investment adviser custody rule, to accommodate advisers to funds of hedge funds. Under the current rule, an adviser acting as general partner to a pooled investment

vehicle, including a hedge fund, has custody of the pool's assets, and therefore must deliver custody account information to investors. An adviser to a fund may comply with this requirement by distributing the fund's audited financial statements to investors within 120 days of the fund's fiscal year end.⁶ Because the underlying funds may not conclude their audits within 120 days, however, advisers to funds of hedge funds will have difficulty in completing their own audits with the 120 day limitation. For this reason, the Commission is proposing to extend the period in which custody account information is distributed for pooled investment vehicles to 180 days.

The Commission's Reasons For the Proposal

Among the reasons the Commission gives for proposing to require hedge fund adviser registration is its concern with the increase in fraud-related enforcement cases involving hedge funds and the "retailization" of hedge fund investments, facts seen by the Commission as requiring increased protections for hedge fund investors. As evidence of this trend, while acknowledging that hedge funds are not today typically sold to small investors, the Commission notes that funds of hedge funds that have registered their securities under the Securities Act of 1933 have made themselves available to such investors. It further argues that pension funds, universities and charitable institutions are investing in hedge funds, and that their assets should be protected against the risks of investing in hedge funds: "Losses resulting from hedge fund investments, as with any other investment loss, may affect the entities' ability to satisfy their obligations to their beneficiaries or pursue other intended purposes." The Commission also expresses concern about the rapid growth of hedge fund investments, and says that it believes that hedge fund advisers will be unduly pressured to increase profitability by engaging in frauds, which "can harm ordinary citizens who in many cases are now their ultimate beneficiaries."

Another reason the Commission gives for proposing to require hedge fund advisers to register under the Advisers Act is that the Commission could thereby gain important but currently unavailable information about hedge funds generally, including information about the number of hedge funds that advisers manage, the amount of assets in hedge funds, the number of employees and types of clients that these advisers have, other businesses that they conduct, and the identity of persons that control or are affiliated with such advisers. Registration will permit the screening of individuals associated with the adviser to weed out persons

convicted of felonies or otherwise subject to disqualifications. In addition, registration under the Advisers Act will give the Commission and its staff authority to conduct examinations of the adviser's hedge fund activities, which the Commission believes will deter wrongdoing and encourage better pricing practices. Once it is registered, an adviser to a hedge fund would have to adopt policies and procedures designed to prevent violations of the Advisers Act and would have to designate a Chief Compliance Officer. Because its examination staff resources are limited, the Commission expects to rely upon the Compliance Officers to serve as the frontline watch for violations of securities laws and to provide protection against conflicts of interests. Finally, the Commission believes that requiring registration of hedge fund advisers will impose only minimal additional burdens on them, since the full disclosure of conflicts of interest and prohibitions against fraud apply regardless whether the adviser is registered.

The Commission acknowledged that many hedge fund advisers are already registered with the Commodity Futures Trading Commission ("CFTC") as commodity pool operators or commodity trading advisors. However, the Commission's proposal does not contain any relief for CFTC registrants — they would be subject to the full scope of regulatory requirements under both statutory schemes.

While, on first blush, the registration of hedge fund advisers under the Advisers Act may seem innocuous, there is a distinct possibility that, in the absence of detailed rules governing significant aspects of advisers' conduct (e.g., allocation of investment opportunities, valuation of assets that do not have established markets, conflicts of interest involving different fee structures for different clients, performance presentation, and the like), staff examiners could subject hedge fund advisers to "regulation by examination," free of the normal protections provided by the Administrative Procedure Act and public comment process. Thus, the Commission's purported "first step" actually might result in more extensive regulation of hedge fund advisers than has been advertised.

The Dissenting View

In their written dissent to the proposing release, Commissioners Glassman and Atkins argue that before the Commission goes about systematically collecting information about hedge funds, it should determine what information is actually wanted or needed, and whether adviser registration will provide the information necessary to discover and deter hedge fund fraud. They noted that the 1999 report of the President's Working Group on

Financial Markets⁷ following the near collapse of Long Term Capital Management, a large hedge fund, had concluded that registration of investment advisers to hedge funds was not warranted. Although the Commission's staff recommended in its 2003 study that the Commission consider requiring such registration, the staff found no evidence of "retailization" in the hedge fund industry and no significant increase in fraud. Yet those "concerns" form the basis for the Commission's registration proposal. The dissenters point out that registration alone is unlikely to deter fraud and that many of the frauds that have been detected have involved registered (as opposed to unregistered) advisers. For instance, the fact that both mutual funds and their advisers are registered did not prevent the recent mutual fund market timing and late trading scandals. Furthermore, the dissenters argue that the information provided on Form ADV is insufficient to deter fraud and raise this point of caution: "Perhaps it is proponents' realization that the Form ADV may not provide all the information they need that causes them to characterize the proposal to require hedge fund advisers to register as a modest first step. This begs the question of what this is a first step towards." In addition, the dissenters claim that the proposal understates the costs involved in registration under the Advisers Act, particularly with respect to the costs associated with responding to risk-based examinations by the Commission's staff, since the majority views hedge fund advisers as ideal candidates for the risk-based approach. The dissenters are concerned that without clearly identified red flags upon which to base an examination, a high performing hedge fund could attract extra Commission scrutiny, complete with repeated, ad-hoc requests for paper and electronic documents. Instead, the dissenters would have the Commission undertake a further study that focuses on identifying the qualitative and quantitative information that would raise red flags for potential fraud and provide systematic data on hedge fund trends and practices before requiring wholesale registration of hedge fund advisers.

Endnotes

¹ This paper is intended as a brief description of recent SEC action and not as legal advice.

² See Investment Advisers Act Release No. 2266 (July 20, 2004), 69 FR 45172 (July 28, 2004), available on the Commission's Web site at <http://www.sec.gov/rules/proposed/ia-2266.htm>.

³ Section 3(c)(1) exempts issuers whose outstanding securities are beneficially owned by 100 or fewer persons and that are not making and do not presently propose to make a public offering of their securities, while Section 3(c)(7) exempts those issuers whose outstanding securities are owned exclusively by persons who were qualified purchasers at the time of acquisition and that are not making and do not at that time propose to make a public offering of their securities.

⁴ The Commission believes that this is necessary to prevent an unregistered hedge fund adviser from providing its services to thousands of mutual fund investors through fourteen or fewer mutual funds, each of which could invest in the private fund and each of which would count as a single client.

⁵ This, of course, would preclude hedge funds that now charge performance fees from accepting new investors who are not qualified clients unless those fee structures are changed.

⁶ See Advisers Act Rule 206(4)-2(b)(3).

⁷ The President's Working Group consists of the Secretary of the Treasury and the Chairmen of the Federal Reserve, the Commission and the CFTC.

For Further Information

If you have any questions concerning this memorandum or the Commission's hedge fund adviser proposal, please call any of the following members of our Securities and Futures Market Regulation Group in our Washington D.C., Chicago and Atlanta offices:

Andrew M. Klein	aklein@schiffhardin.com	t 202.778.6415
Howard L. Kramer	hkramer@schiffhardin.com	t 202.778.6414
Laura S. Pruitt	lpruitt@schiffhardin.com	t 202.778.6470
Michael L. Meyer	mmeyer@schiffhardin.com	t 312.258.5713
Carl A. Royal	croyal@schiffhardin.com	t 312.258.5707
Michael K. Wolensky	mwolensky@schiffhardin.com	t 404.806.3820
Ethan H. Cohen	ecohen@schiffhardin.com	t 404.806.3822

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