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SEC Confirms It Will Propose Hedge Fund Adviser Registration Requirements

Securities and Exchange Commission (“SEC” or “Commission”) Chairman William Donaldson announced this morning that the SEC staff is preparing a proposed rule requiring the registration of hedge fund managers as investment advisers.¹ Although the rule proposal was thought likely, this is the first time the SEC has publicly confirmed the rule will be proposed. Chairman Donaldson stated that the proposal is necessary in order to provide the SEC “an oversight role in the explosive growth of hedge funds.”²

Chairman Donaldson emphasized that the objective of the proposed requirement is to give the SEC a reliable means of collecting information on the hedge fund industry, and not about requiring disclosure on hedge fund investment strategies and techniques. The Chairman pointed out that even though hedge fund advisers manage significant sums of money for a large number of investors, they avoid registration by indirectly accessing clients through pooled vehicles. In addition, Chairman Donaldson noted that as the hedge fund industry rapidly approaches the trillion dollar mark and with the tremendous increase

in the number of hedge fund investors, it is crucial that the SEC gain some regulatory oversight.³

Last fall, the SEC staff released a report on the “Implications of the Growth of Hedge Funds”⁴ The report was a culmination of the SEC’s investigation of the hedge fund industry that it commenced in June 2002. In the report the staff outlined the nature of the hedge fund industry, the current regulatory framework, the staff’s concerns with hedge fund practices, and recommendations to the SEC for modifying the regulation of hedge funds and hedge fund managers.⁵ The report stressed that the SEC’s greatest areas of concern included the SEC’s limited ability to obtain comprehensive and reliable information about hedge funds. In his speech this morning, Chairman Donaldson further added that in the SEC’s recent investigations of the mutual fund industry, hedge funds were often found to be active participants in the scandals.

¹ Speech by SEC Staff: Remarks to the Practising Law Institute, by William H. Donaldson, Chairman U.S. Securities and Exchange Commission, Washington, D.C. (March 5, 2004).

² *Id.*

³ *Id.*

⁴ *Implications of the Growth of Hedge Funds*, Staff Report to the SEC, (September 2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

⁵ See Dechert Financial Services Update 2003-68 (October 23, 2003) (“SEC Releases Staff Report on Hedge Funds”).

The SEC will solicit comments from all interested parties to ensure that the rule effectively balances giving the Commission a regulatory role in the industry while still allowing hedge funds enough independence to continue thriving in the financial markets.

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Recent Dechert Client Memoranda on Hedge Fund Investigation Developments:

- Financial Services Update No. 2 -- NASD Permits the Use of Related Performance Information in Sales Materials for Private Equity and Hedge Funds Sold to Qualified Purchasers (January 13, 2004).
- Financial Services Update No. 68 -- SEC Releases Staff Report on Hedge Funds (October 10, 2003).
- Financial Services Update No. 65 -- NASD Clarifies Hedge Fund Views in Response to SIA Inquiry (October 3, 2003).
- Financial Services Update No. 29 -- House Follows SEC Roundtable with Hearing on Hedge Funds (May 23, 2003).
- Financial Services Update No. 28 -- SEC Holds Hedge Fund Roundtable (May 20, 2003).
- Financial Services Update No. 6 -- NASD Issues Reminder on Hedge Fund Sales (January 31, 2003).
- Client Memo 2002-37 -- Hedge Funds, Private Funds and Offshore Funds: Anti-Money Laundering Program Rule Proposed with a Requirement to Register with FinCEN as the SEC Investigation Continues (October 1, 2002).
- Client Alert -- Proposed Rule Requiring Anti-Money Laundering Programs for Unregistered Investment Companies, including Hedge Funds and Offshore Funds, and Requiring Those Funds to Identify Themselves to FinCEN (Sept. 19, 2002).
- Client Alert -- SEC Increases Private Fund Scrutiny (June 3, 2002).

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