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A client alert from Dechert's Financial Services Group

The SEC Proposed Hedge Fund Adviser Registration Requirements

Yesterday the U.S. Securities and Exchange Commission (SEC) proposed a new rule 203(b)(3)-2 under the Investment Advisers Act of 1940 ("Advisers Act") that would require many hedge fund managers, both in the U.S. and abroad, to register as investment advisers with the SEC.

Under Section 203 of the Advisers Act, an investment adviser is required to register with the SEC if the adviser has had 15 U.S. clients or more during the preceding 12 months, or if it acts as the adviser or sub-adviser to a mutual fund registered with the SEC under the Investment Company Act of 1940 ("Investment Company Act"). Current rule 203(b)(3)-1 under the Advisers Act states for the purposes of Section 203 that an entity that receives investment advice based on its objectives rather than those of the individual investors should be treated as a single client. As a result, each hedge fund is currently treated as a single client.

While the text of the proposed rule and the related commentary have not yet been released, some general information has been provided at the meeting where the proposal was approved. Under the proposed rule 203(b)(3)-2, investment advisers to a "private fund" would be required to "look through" the fund to count the underlying investors. A "private fund" would be defined as a fund that: is not required to be regulated as an investment company under the Investment Company Act because of an exception from the definition of "investment company" under Section 3(c)(1) or 3(c)(7); permits an investor to redeem its investment within two years (thus, exempting a number of funds known as "private equity" or "venture capital" funds); and is offered based on

its adviser's profile. Consequently, the new rule, if adopted in its current form, would require U.S. investment advisers to register with the SEC if they act as investment adviser to a fund or funds that have 15 or more investors (non-U.S. advisers would only have to count their U.S. investors). With respect to funds of hedge funds, statements by the SEC staff yesterday indicated that an investment adviser to an underlying hedge fund would have to "look through" a fund of hedge funds when counting its clients. The proposed rule applies to all "private funds" sold in a private placement in the United States. It includes, therefore, foreign hedge funds, and its application to foreign retail mutual funds is questionable.

The rule proposal follows a report on the "Implications of the Growth of Hedge Funds" released last fall by the SEC staff.¹ 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.² 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 absent mandatory registration of their advisers. Yesterday, echoing the report, SEC Chairman

¹ *Implications of the Growth of Hedge Funds*, Staff Report to the SEC (September 2003), available at <http://www.sec.gov/news/studies/hedgcfunds0903.pdf>.

² See Dechert Financial Services Update 2003-68 (October 23, 2003) ("SEC Releases Staff Report on Hedge Funds").

Donaldson emphasized that the objective of the proposed rule is to provide the SEC with vital information about the hedge fund industry; make available additional information to investors and deter violations of U.S. securities laws by hedge fund managers that, once registered, would have to adopt compliance policies and procedures; designate a chief compliance officer; and maintain books and records in a manner that will help them comply with their fiduciary duties.

Approval of the proposal was not unanimous; two of the five SEC commissioners voted against the proposal. Although SEC votes are typically unanimous, yesterday's

vote was the second split vote in recent weeks. SEC Commissioner Atkins spoke against the proposal, and he insisted that a dissenting opinion be included in the public release of the SEC rule proposal. He invited the public to submit comment letters on the proposal to explain that the SEC and its staff may reach their investor protection goals through other means than this rulemaking. All comments must be submitted by September 15, 2004.

The proposed rule has not yet been released to the public. When it is, Dechert LLP will distribute a more detailed Client Memorandum.

Practice group contacts

If you have questions regarding the information in this update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/financialservices.

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