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The SEC Proposal to Register Hedge Fund Advisers

The U.S. Securities and Exchange Commission has issued its long-awaited proposal to require "hedge fund" advisers to register as investment advisers. The proposal would require hedge fund advisers with more than 14 investors and $30 million under management to register; smaller advisers would be potentially subject to State registration requirements. The proposal is intended to exclude from the registration requirement advisers to private equity and venture capital funds, by excluding funds that do not provide redemption rights within two years following an investment. In addition, advisers to non-U.S. mutual funds are generally excluded, regardless of the jurisdiction in which the adviser is located. Special rules apply to non-U.S. advisers; such advisers would be permitted to avoid many of the requirements of SEC registration if their only U.S. clients are investors in offshore funds. The proposal also includes provisions designed to facilitate the transition to registration if the proposal is adopted, by extending the deadline under the custody rule for registered advisers electing to provide a fund's audited financial statements to investors. Finally, the proposal includes several changes to Form ADV.

The SEC is accepting comments on the proposal until September 15, 2004. Interested parties should consider commenting, particularly if elements of the proposal will not achieve their stated objectives or will have unintended consequences.

Summary of the Rule

The rule proposal would require an investment adviser whose principal office and place of business is in the United States to count each investor in a "private fund" as a client for the purpose of determining whether an adviser is exempt from registration under the "private adviser exemption," which exempts from registration investment advisers with fewer than 15 clients in a 12-month period. The rule proposal would require an investment adviser whose principal office and place of business is located outside the United States to count only U.S. investors as clients for the purpose of determining eligibility under the exemption. In an effort to include hedge funds, but exclude private equity and venture capital funds, "private fund" is defined in the rule proposal as an unregistered investment fund sold upon reliance on Section 3(c)(1) or 3(c)(7) that permits redemptions of any portion of an investor's interest within two years of purchase (with certain exceptions for reinvested dividends and hardship situations). The definition also excludes foreign funds that make a public offering of their securities outside the United States and are registered as public investment companies in a foreign jurisdiction.

The rule proposal also includes several related changes to existing SEC requirements for investment advisers that are intended to alleviate the transition to registration for advisers with respect to recordkeeping and charging performance fees. The rule proposal provides relief to unregistered fund of funds managers under the custody rule by permitting audited financial statements to be provided to investors within 180 days rather than the current 120 days. Finally, the rule proposal includes certain revisions to Form ADV that would require additional information with respect to private funds managed by an investment adviser.

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Background

Many hedge fund advisers avoid registration under the Investment Advisers Act of 1940 ("Advisers Act") by relying upon the "private adviser" exemption contained in Section 203(b)(3) of the Advisers Act. Under this section, an investment adviser is not required to register with the Securities and Exchange Commission ("SEC") if it has had fewer than 15 clients during the preceding 12 months and neither holds itself out to the public as an investment adviser nor acts as the investment adviser to a mutual fund registered with the SEC under the Investment Company Act of 1940 ("Investment Company Act"). A hedge fund has historically been counted as one client for these purposes. Current Rule 203(b)(3)-1 under the Advisers Act provides, for the purpose of Section 203(b)(3), that an entity that receives investment advice based on its collective objectives rather than those of the individual investors is treated as a single client.[1] As a result, investment advisers that advise hedge funds are currently able to treat each fund managed as a single client, which effectively enables hedge fund managers to avoid SEC registration if they confine their activities to advising hedge funds. On July 14, 2004, the SEC proposed to amend Rule 203(b)(3)-1 and adopt a new Rule 203(b)(3)-2 under the Advisers Act, along with certain other revisions (collectively the "Rule Proposal") that would require an investment adviser to "look through" certain funds to count the number of clients for purposes of this exemption.[2] Certain U.S. investment advisers not registered with the SEC who rely on Section 222 of the Advisers Act and Rule 222-2 thereunder to avoid registration with the States (the "blue sky pre-emption") may also have to look through certain funds to count the number of clients they have in a State for purposes of determining whether they are eligible for the blue sky pre-emption.[3]

The Rule Proposal follows a report on the "Implications of the Growth of Hedge Funds" (the "Staff Hedge Fund Report") released last fall by the SEC staff.[4] In the Staff Hedge Fund Report, the staff outlined the nature of the hedge fund industry, the current regulatory framework that applies to hedge funds, 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 Staff Hedge Fund Report stressed that one of the staff's greatest areas of concern is the SEC's limited ability to obtain comprehensive and reliable information about hedge funds absent mandatory registration of their advisers. The staff recommended, among other things, that both domestic and offshore hedge fund managers register as investment advisers under the Advisers Act and that the Form ADV be amended to customize the disclosure provided by hedge fund managers to investors.

Rationale of the Rule

While presenting the proposed rule, SEC Chairman Donaldson mentioned that the new rule and rule amendments implement the principal recommendations of the Staff Hedge Fund Report. In addition, the Proposing Release states that the Rule Proposal is based on the following considerations, many of which echo the Staff Hedge Fund Report:

Growth of Hedge Funds. Over the past 10 years, the estimated assets in U.S. hedge funds have increased fifteenfold, the number of hedge funds has increased more than fivefold, and hedge funds play a growing role in the U.S. securities markets as large and frequent traders of securities. For example, the Proposing Release mentions that hedge funds account for about 95% of all trading in convertible bonds. However, due to their unregulated nature and the absence of registration requirements for hedge fund managers, the SEC notes

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1 Rule 203(b)(3)-1 indicates that an investment adviser whose principal office and place of business is in the United States must count each such investor as a client but that an investment adviser whose principal office and place of business is located outside the United States must only count U.S. persons as clients for the purpose of determining eligibility under the exemption.

2 *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Rel. No. IA-2266 (July 20, 2004) [hereinafter "Proposing Release"], *available at* http://www.sec.gov/rules/proposed/ia-2266.htm.

3 Advisers not registered with the SEC generally may be required to register by the States where they do business. Section 222, however, provides, among other things, that no U.S. State may require an investment adviser to register with the State if the adviser has no place of business located within the State and has had fewer than six clients who are resident of that State in a 12-month period. Rule 222-2 provides that for purposes of this part of Section 222, an investment adviser may rely upon the definition of "client" provided by Rule 203(b)(3)-1. Thus, as a consequence of the Rule Proposal, an unregistered investment adviser to certain funds may have to look through the funds to count clients and may have to register with a State if there are more than five investors in the funds who are resident of the State.

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").

in the Proposing Release that it lacks reliable information about the hedge fund industry.

Growth of Hedge Fund Fraud. The SEC states in the Proposing Release that the growth in hedge funds has been accompanied by a substantial and troubling growth in the number of hedge fund fraud enforcement cases. Hedge fund fraud involves in particular: investment advisers that overstate the performance of their hedge funds; advisers that cause hedge funds to pay unnecessary and undisclosed commissions; advisers that misappropriate client assets; and advisers to hedge funds that have allegedly been key participants in the recent scandals involving mutual fund late trading and inappropriate market timing.

"Retailization" of Hedge Funds. The SEC notes in the Proposing Release that there is a growing exposure of smaller investors, pensioners, and other market participants, directly or indirectly, to hedge funds. For example, the development of retail "funds of hedge funds" in recent years has made hedge funds more broadly available to the public. A growing number of public and private pension funds, as well as foundations and charitable organizations, have begun to invest in hedge funds or have increased their allocations to hedge funds. In addition, the Proposing Release pointed out the trend in other jurisdictions toward retailization, which would create additional pressures in the U.S. market.

In considering these issues, the SEC emphasized the following points:

- The Rule Proposal is consistent with the purpose of Section 203(b)(3). The SEC notes that the "private adviser" exemption was not intended to exempt from registration advisers whose clients are limited to wealthy or sophisticated clients, as is sometimes argued by opponents of the Rule Proposal.[6] Opponents argue that such investors can fend for themselves and do not need the protections of the Advisers Act. The SEC mentions in the Proposing Release that wealthy and sophisticated investors were the primary clients of many investment advisers in 1940 when Congress enacted the Advisers Act. To the contrary, the exemption appears to reflect Congress's view that there is no federal interest in regulating investment advisers with only a small number of clients. Today, however, many investment advisers take advantage of the exemption to operate pooled investment vehicles such as hedge funds with a large number of investors and no SEC oversight.

- The SEC's current regulatory program, which relies almost entirely on enforcement actions brought after the malfeasance has occurred, is inadequate. By subjecting hedge fund managers to the SEC's inspection program, the SEC believes compliance problems could be identified at an early stage and unlawful conduct could be deterred. In particular, the SEC identified valuation as an area of regulatory concern with respect to hedge funds.

- The SEC lacks basic information about hedge fund advisers and the hedge fund industry and must rely on less reliable third-party data. Hedge fund adviser registration would provide the SEC with important information about this segment of the industry. The SEC notes in the Proposing Release that there is legislative history showing that collecting information about the nation's investment advisers is one aim of the Advisers Act.

- While acknowledging the important role that hedge funds play in the securities markets in contributing to market efficiency and liquidity, the SEC noted that hedge funds present unique risks to the securities markets and investors that include, but go beyond, protecting the investors in hedge funds. The SEC believes that registration with the Commission would help to prevent unfit persons from using hedge funds to perpetrate frauds.

- Registration would subject hedge fund advisers to the new compliance rules and require these advisers to adopt policies and procedures that are reasonably designed to prevent violations of the Advisers Act and to designate a chief compliance officer. The Rule Proposal acknowledges the limitations of its examination program in preventing and detecting fraud and states that registration will create a culture of compliance and, in effect, place the chief compliance officer in the position of a private enforcer of federal securities laws.

- Registration would help limit the retailization of hedge funds. In particular, it would require all direct and indirect investors to meet the "qualified client" standards of Rule 205-3 (i.e., a net worth of at least $1.5 million or at least

[6] Hedge funds generally avoid registration under U.S. laws by being offered privately only to certain wealthy and/or sophisticated investors. Certain opponents of the Rule Proposal argue that wealthy and sophisticated investors do not require the protections that could be provided if hedge fund advisers were registered with the SEC under the Advisers Act and subject to the SEC's inspection program.

$750,000 under management with the adviser) if the adviser wants to charge a performance fee.[7]

- Registration would further the important objectives noted above while imposing only minimal additional burdens on advisers.

Specific Provisions of the Rule Proposal

Amendment of the 14 Client Exemption for Private Fund Managers

Currently, Rule 203(b)(3)-1(a)(2) permits an investment adviser to consider as a single client "a corporation, general partnership, limited partnership, limited liability company, trust..., or other legal organization" to which investment advice is provided based on the organization's investment objectives rather than the individual investment objectives of an underlying investor. The Rule Proposal would explicitly exclude "private funds" as defined thereunder from being able to rely on the Rule 203(b)(3)-1 safe harbor. With respect to advisers to hedge funds in which a registered investment company invests, the Rule Proposal would require the adviser to look through the hedge fund investor (the registered fund) and count each shareholder in the registered investment company as an individual client.

Under the Rule Proposal, an investment adviser whose principal office and place of business is in the United States would need to count each investor in the "private fund" as a client for the purpose of determining whether an adviser is exempt from registration under Section 203(b)(3). However, the Rule Proposal would require that an investment adviser whose principal office and place of business is located outside the United States only count investors in the private fund that are U.S. residents for the purpose of determining eligibility under the exemption. (There is no definition of the term "U.S. resident" in the Proposing Release, but the SEC staff generally considers that the term U.S. resident has a meaning similar to that of "U.S. Person" as defined in Regulation S under the Securities Act of 1933.[8]) Similarly, the Rule Proposal would permit such an offshore adviser to treat an offshore private fund as its client (and not the investor's) for all purposes under the Advisers Act other than determining the availability of the private adviser exemption and the antifraud provisions of the Advisers Act, Sections 206(1) and 206(2). Moreover, because such an offshore fund would not be a U.S. client of the offshore adviser, however, under current SEC staff guidance, the Advisers Act's substantive provisions generally would not apply to the adviser's dealing with the fund; the offshore adviser, among other things, would have to comply with the Advisers Act's recordkeeping requirements with respect to the fund and its other clients, and would have to undertake to promptly provide such records to the SEC upon request and make its personnel available for testimony before, or questioning by, the SEC or its staff.[9]

Definition of Private Fund

Under the Rule Proposal, Rule 203(b)(3)-2(d)(1) would define "private fund" as a company that would be an investment company under Section 3(a) of the Investment Company Act, but for the exceptions provided in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act[10] and that permits owners to redeem any portion of their ownership interests within two years and which offers interests based on the investment advisory skills, ability, or expertise of the investment adviser.

However, the Rule Proposal would exclude from the definition of "private funds" a company that permits its owners to redeem their ownership interests within two years in the case of:

(i) events found after reasonable inquiry to be extraordinary and unforeseeable at the time of issuance; and

(ii) interests acquired with reinvested dividends.

The two-year lock-up requirement is designed to exclude private equity and venture capital funds but does not

[7] As noted, there would be a grandfather provision for existing investors.

[8] *See Murray Johnstone Holdings Ltd.*, SEC No-Action Letter (pub. avail. Oct. 7, 1994).

[9] *See, e.g., Uniao de Bancos de Brasileiros S.A.* , SEC No-Action Letter (pub. avail. July 28, 1992).

[10] Hedge funds generally are structured to come under the "private" investment company exceptions from the definition of investment company found in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act in order to avoid registration and regulation thereunder. In order to satisfy Sections 3(c)(1) and 3(c)(7), the hedge fund entity must not conduct a public offering of its shares and generally must, for 3(c)(1) purposes, limit its number of investors to less than 100 persons, and, for 3(c)(7) purposes, limit its investors to persons who are "qualifying purchasers." Offshore funds may generally apply the counting or qualification requirements just to their U.S. investors and limit the private offering requirement to their U.S. offerings.

depend upon the nature of the fund beyond the lock-up provision.

The definition excludes companies with a principal office and place of business outside the United States that make a public offering of their securities outside the United States and are regulated as a public investment company under the laws of another country. This provision is intended to exclude non-U.S. mutual funds. However, it likewise does not depend upon the nature of the fund beyond the determination by any non-U.S. government to permit its public offering and regulate it as a fund.

Change to Recordkeeping Requirements

The Rule Proposal would amend current recordkeeping requirements under Rule 204-2(e)(3)(ii) to permit advisers that are subject to the Advisers Act registration requirements for the first time as a result of the Rule Proposal to utilize performance information for periods that pre-date the adviser's registration without having the records for the period of time that would otherwise be required to support the performance claims. The Rule Proposal also explicitly provides that books and records of a private fund managed by an adviser shall be deemed to be the records of the adviser for purposes of Section 204 of the Advisers Act.

Change to Performance Fee Rules

The Rule Proposal includes a new section in Rule 205-3 that permits advisers that were previously exempt from registration before enactment of the Rule Proposal to charge performance fees to current clients in existing funds, notwithstanding the prohibitions of Rule 205-3(b), which places limitations on the ability of managers to charge performance fees.

Change to Custody Rules

Under the Rule Proposal, Rule 206(4)-2(b)(3) would be amended to permit a pooled vehicle to provide its audited financial statements to investors in lieu of a quarterly account statement within 180 days (rather than 120 days) of the end of its fiscal year. Although this change is intended to provide relief to funds of funds, the longer time period would be available to all hedge funds. The SEC indicated in the Proposing Release that, until it takes action on this portion of the Rule Proposal, the SEC's Division of Investment Management will not recommend any enforcement action against an investment adviser to a fund of funds that acts in accordance with the proposed amendment.

Changes to Form ADV

The Rule Proposal would require that Form ADV contain a new Item 7 that requires the adviser to disclose if it is a general partner or manager or adviser to a private fund and, if so, the adviser must provide information in Schedule D regarding private funds advised by the adviser as well as a listing of all funds in Item 7(b) and certain other information regarding investors in the private funds.

Dissenting Opinions

The approval of the proposal was not unanimous. Two of the five SEC commissioners voted against it. At the July 14 meeting at which the Rule Proposal was approved, SEC Commissioners Glassman and Atkins spoke against the proposal and insisted that their dissenting opinion be included in the Proposing Release.[11] The dissenting commissioners criticized the explanations put forward by the other SEC commissioners and staff supporting the proposal to require investment advisers to hedge funds to register. In particular, they believe that there are more effective methods to obtain information about the hedge fund industry and that the SEC should explore alternative approaches. They pointed out that hedge funds have long been the subject of SEC study and that the SEC has taken the position several times in the past that requiring hedge fund managers to register as investment advisers would not be an appropriate method to monitor hedge fund activity. Thus, they asserted that a change of position would require additional research and consideration. They argued that the SEC staff did not cite evidence of retailization or an increase in hedge fund fraud in the Staff Hedge Fund Report. They do not believe that requiring registration will reduce the amount of fraud by hedge fund managers. They also questioned the proposed definition of "private fund" by reference to a two-year lock-up period because hedge fund managers are likely to lengthen the current redemption periods of their hedge funds, which would not benefit investors. Finally, the two dissenting commissioners argued that the proposal, if adopted, will result in increased costs to hedge fund investors and will require the SEC to invest substantial

[11] Dissenting opinions by commissioners are uncommon, but not unprecedented. Commissioners Glassman and Atkins also published a dissenting opinion to the Final Rule Release on Investment Company Governance, SEC Rel. No. IC-26520 (July 27, 2004). Prior to the two recent Glassman-Atkins dissents, we are only aware of 10 dissenting opinions that have been published since the SEC was established, the most recent in 1998.

resources and expertise to monitor the hedge fund industry that, arguably, it does not yet have.

Request for Comments

The SEC has set a 60-day comment period beginning on the initial date that it approved the Rule Proposal so that commenters have until September 15, 2004, to submit comments. The comment process allows members of the public to provide their views and practical expertise to the SEC and staff. Such comments also become part of the public record. There have been numerous instances, particularly during the SEC's recent rule-making activity, where proposed rules have been modified in response to comments. Details on how to submit comments are available in the Proposing Release. The SEC specifically seeks comments with respect to the following areas:

Burdens of Registration

- The SEC has inferred from the fact that many hedge fund advisers voluntarily register that, "in practice, advisers do not consider registration burdensome." Is this inference warranted?
- Specifically, the SEC has requested that advisers who have voluntarily registered comment regarding the impacts and burdens of registration.
- In light of the SEC's accommodation to hedge fund managers in adopting the custody rules, are there changes that should be made to other rules or forms to tailor them to hedge fund advisers?

Offshore Advisers and Funds

- Should offshore advisers be required to look through their offshore funds only if assets attributable to U.S. residents comprise more than a threshold percentage?
- Would registration present conflicts to advisers registered in multiple jurisdictions who would be faced with conflicting regulatory requirements?
- Is the scope of the exemption for funds that are regulated as a public investment company outside the United States too broad or narrow?

Assets under Management

- The Rule Proposal does not alter the $30 million threshold for required registration.[12] Is the $30 million dollar threshold for registration under the Advisers Act appropriate? Should it be lower given that some of the frauds involving hedge fund advisers involve advisers with less than $25 million under management (a point noted by the dissenters)?

Definition of Private Fund

- Should "private fund" include private equity, venture capital, and other investment pools that are not hedge funds?
- Do the three characteristics used in the rule effectively distinguish hedge funds from the other types of funds?
- Is two years an appropriate time period for redemptions?

In addition, in their dissenting opinion, SEC Commissioners Glassman and Atkins expressly solicited comments from opponents of the proposal, in particular to explain that the SEC and its staff may reach their investor protection goals through alternative means.

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[12] Under the Advisers Act, advisers with less than $25 million under management generally are not permitted to register with the SEC, while registration is optional for amounts under management between $25 million and $30 million.

Practice group contacts

If you have questions regarding the information in this legal 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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