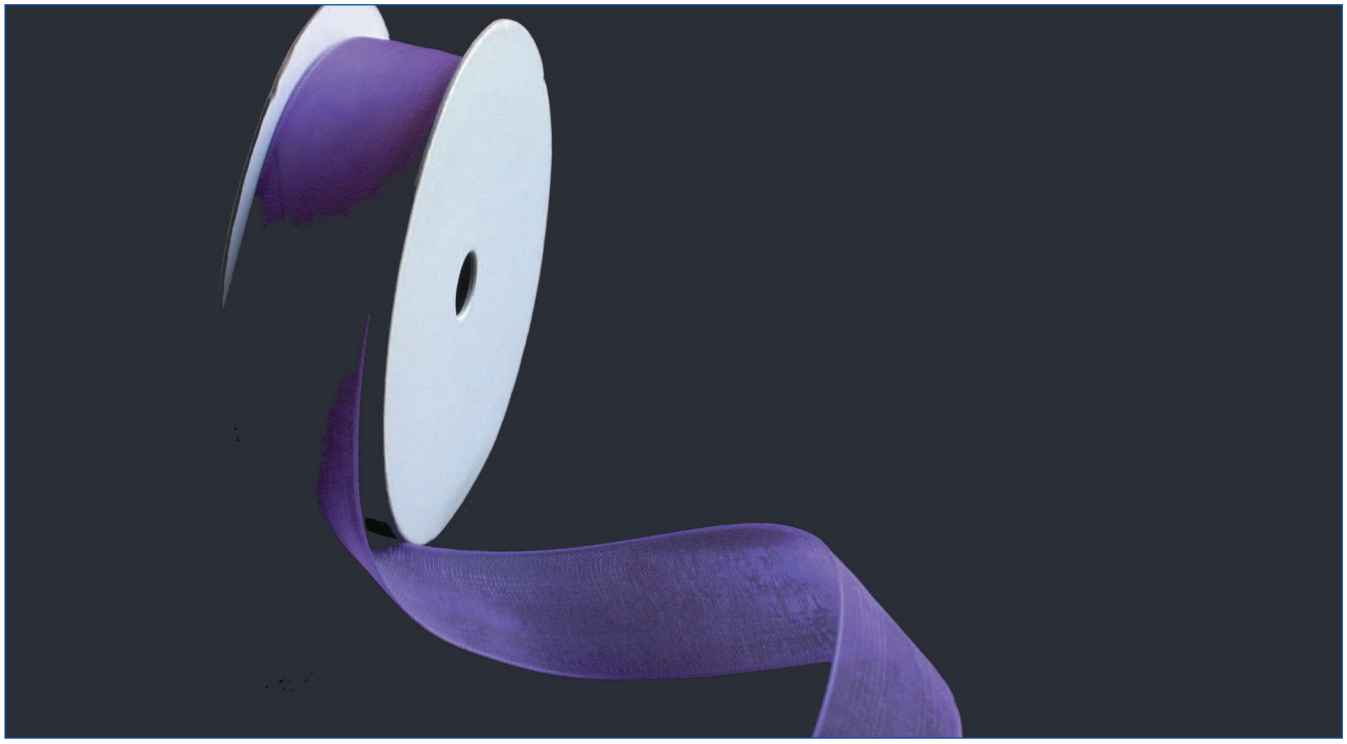
Unravelling SEC registration



A new US Securities and Exchange Commission proposal may adversely affect smaller hedge funds. **George Mazin**, partner at legal firm Dechert LLP, examines the fine print

MANY HEDGE fund advisers currently avoid registration under the Investment Advisers Act of 1940 by relying upon the 'private adviser' exemption contained in the Act.

An investment adviser is not required to register with the Securities and Exchange Commission (SEC) if they have had fewer than 15 clients during the preceding 12 months, do not hold themselves out to the public as an investment adviser or act as the investment adviser to a mutual fund registered with the SEC under the Investment Company Act of 1940.

Historically, a hedge fund has been counted as one client for these purposes and as a result, investment advisers who advise hedge funds can currently treat each fund managed as a single client. This has enabled hedge fund managers to avoid SEC registration.

On 14 July, however, the SEC proposed to amend the Advisers Act (the rule proposal) by adopting a new rule that would require an investment adviser to 'look through' certain funds, and to count each investor in the fund as a client for the purposes of this exemption.

Advisers to private equity and venture capital funds will avoid registration rules by excluding funds that do not provide redemption rights within two years following an investment.

In addition, advisers to non-US mutual funds are

generally excluded, regardless of the jurisdiction in which the adviser is located. Special rules apply to non-US advisers, who would be permitted to avoid many of the requirements of SEC registration if their only US clients are investors in offshore funds.

Why change?

The rule proposal follows a report on the implications of the growth of hedge funds – *The Staff Hedge Fund Report* – released last autumn by the SEC. William Donaldson, chairman of the SEC, says the new rule and its amendments implement the principal recommendations of the *The Staff Hedge Fund Report*. The rule proposal is based on the following considerations, many of which echo the report:

■ Growth of hedge funds
Over the past 10 years, the estimated assets in US hedge funds have increased fifteen-fold. The number of hedge funds has increased more than five-fold and they play a growing role in the US securities markets as large and frequent traders of securities. The proposing release mentions that hedge funds account for around 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 lacks reliable information about the hedge fund industry.

■ Fraud
The SEC believes 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: investment advisers who overstate the performance of their hedge funds; advisers who cause hedge funds to pay unnecessary and undisclosed commissions; advisers who misappropriate client assets; and advisers to hedge funds who have allegedly been key participants in the recent scandals involving mutual fund late trading and inappropriate market timing.

■ Retail funds
The SEC notes there is a growing exposure of smaller investors, pensioners, and other market participants to hedge funds. The development of retail funds of hedge funds in recent years has made hedge funds more available to the public. A growing number of public and private pension funds, as well as foundations and charitable organisations 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 'retailisation' which would create additional pressures in the US market.

Specific provisions

Under the rule proposal, an investment adviser whose principal office and place of business is in the US 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.

An investment adviser whose principal office is located outside the US would only be required to count investors in the private fund who are US residents for the purpose of determining the availability of the exemption.

Similarly, the rule proposal would permit an offshore adviser to treat an offshore private fund as its client (and not the investors) for most purposes under the Advisers Act. Because an offshore fund would not be a US client of the offshore adviser, under current SEC staff guidance, the Advisers Act's substantive provisions would not apply to the adviser. The offshore adviser would have to comply with the Act's record-keeping requirements and would have to undertake to provide such records to the SEC upon request. They would also be required to make their personnel available for testimony before, or questioning by, the SEC.

Definition of a private fund

A private fund is a company:
- That would be an investment company, but for the exceptions provided in sections 3(c)(1) or 3(c)(7) of the Investment Company Act

"Over the past 10 years, the estimated assets in US hedge funds have increased fifteen-fold. The number of hedge funds has increased more than five-fold"

- That permits owners to redeem any portion of their ownership interests within two years
- 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:
- Events found after reasonable inquiry to be extraordinary and unforeseeable at the time of issuance
- Interests acquired with reinvested dividends.

The two-year lock-up require-

ment is designed to exclude private equity and venture capital funds, but does not depend upon the nature of the fund beyond the lock-up provision.

"The trend in other jurisdictions toward 'retailisation' will create additional pressures in the US market"

The definition excludes companies with a principal office and place of business outside the US that make a public offering of their securities outside the US and are regulated as a public investment company under the laws of another country. This provision is intended to exclude non-US mutual funds.

Current record-keeping requirements would be amended to permit advisers that are subject to registration requirements for the first time as a result of the rule proposal, to utilise performance information for periods that predate the adviser's registration without having the records for such period of time.

Advisers previously exempt from registration before enactment of the rule proposal will be permitted to charge performance fees to current clients even if the clients would not otherwise be eligible to pay performance fees.

Under the proposal, the custody rule 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 for funds of funds, the longer time period would be available to all hedge funds.

The SEC indicated in the proposing release, 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.

Form ADV would contain a new item 7 that requires the adviser to disclose if they are a general partner, manager or adviser to a private fund. 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 14 July 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.

The dissenters criticised the explanations put forward by the other SEC commissioners and staff supporting the proposal to require hedge fund investment advisers to register.

Comments on the rule proposal may be submitted until 15 September 2004. Absent a change in the views of a majority of the commissioners, it is expected that after considering the comments a final rule implementing the proposal will be adopted in the autumn.

Dechert's hedge fund group partners

George J. Mazin (New York) has more than 20 years' experience in domestic and offshore hedge funds, venture capital and private equity investing, and broker-dealer and adviser compliance.

Peter Astleford (London) has more than 20 years' experience advising fund managers, banks and brokers with 15 years' experience in the development and growth of the European hedge fund industry.

Stuart Martin (London) has more than 15 years' experience in advising financial services businesses on product and fund structuring and establishment utilising alternative asset strategies.

David Vaughan (Washington) has more than 12 years' experience working with hedge funds, private US funds, retail and private offshore funds and private and offshore variable insurance products.