SEC ISSUES PROPOSED RULE REQUIRING REGISTRATION OF HEDGE FUND ADVISERS

Introduction

On July 20, 2004, the Securities and Exchange Commission (the "Commission"), by a three-to-two vote, issued a proposed rule that, if adopted, would require advisers to certain private investment pools, such as hedge funds, to register with the Commission under the Investment Advisers Act of 1940 (the "Advisers Act"). The Commission release includes a dissent to the proposal by Commissioners Glassman and Atkins. The Commission will accept comments on the proposal through September 15, 2004. A copy of the proposal is available on the Commission's Web site at www.sec.gov/rules/proposed/ia-2266.htm.

The Proposed Rule

The Current Rule

Section 203(b)(3) of the Advisers Act exempts from registration investment advisers that during the course of a 12-month period have fewer than 15 clients and meet certain other conditions. Rule 203(b)(3)-1 under the Advisers Act currently provides, among other things, that a legal organization (such as a private investment fund) that receives investment advice based on its investment objectives and not the individual investment objectives of its owners is treated as a single client. Under the current rule, private investment fund managers that comply with the other terms of Section 203(b)(3) can advise up to 14 private funds in any 12-month period without registering under the Advisers Act.[1]

New "Look Through" Requirement for "Private Funds"

If the proposal is adopted, new Rule 203(b)(3)-2 would require investment advisers to count each owner of a "private fund" as a client for purposes of determining the availability of the private adviser exemption of Section 203(b)(3) of the Advisers Act. Proposed Rule 203(b)(3)-2 defines a private fund as a company: (i) that would be an investment company under Section 3(a) of the Investment Company Act of 1940 (the "Investment Company Act") but for the exception provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of the Investment

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[1] The investment adviser regulations of certain states do not contain a similar *de minimis* exemption. Accordingly, depending on where its place of business is located, a private investment fund adviser may already be subject to investment adviser registration under state law.

Company Act;[2] (ii) that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and (iii) in which interests have been offered based on the investment advisory skills, ability or expertise of the investment adviser. The two-year redemption test must be applied separately to each investment by an investor in the fund, not just the investor's initial investment. The proposal appears to require the lock-up to begin anew if an investor is permitted to exchange its interest in one fund for an interest in another fund managed by the same adviser.

The exemption for funds not permitting redemptions within two years of purchase is designed to exclude advisers to venture capital and private equity funds from the proposed registration requirements.[3] As currently drafted, however, the proposed rule would allow hedge fund advisers to avoid registration if they impose a two-year lock-up on all their investors. The two-year lock-up that entitles an adviser to avoid the registration requirement would not apply to redemptions within two years of purchase in the case of (i) events that are determined to be extraordinary and unforeseeable at the time the interests were issued, such as an owner's death or total disability, or circumstances that make it illegal or impractical for the investor to continue to own the interest in the fund, and (ii) interests acquired with reinvested dividends. Depending on the language in the final rule, hedge fund advisers may be able to avoid registration by effectively imposing a two-year lock-up on only the principal amount invested.

Funds of Funds Investors

The proposed rule also would require advisers to hedge funds to look through any "top-tier" funds, registered or unregistered, that invest in the hedge fund advised by such adviser, in determining whether the adviser has more than 14 clients.[4]

Limited Relief Permitting Continued Advertising of "Track Records"

Under Rule 204-2(e)(3), a registered adviser that makes claims concerning its performance must maintain documentation supporting those performance claims. Such records must be retained for a period of five years after the performance information is last used. As proposed, a hedge fund

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2 Section 3(c)(1) exempts from registration any issuer the outstanding securities of which are beneficially owned by not more than 100 persons and that does not make a public offering of its securities. Section 3(c)(7) exempts from registration any issuer the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers," and that does not make a public offering of such securities. Private investment funds, including hedge funds, private equity funds and venture capital funds, generally rely on one of these exemptions.

3 In the release, the Commission notes that they have not encountered significant enforcement problems with advisers with respect to their management of these types of funds.

4 The proposal does not require the adviser to the underlying fund to receive information as to the precise number or identities of the top-tier investors other than that the top-tier fund has more than 14 owners.

adviser will continue to be able to use performance information for periods prior to its registration even if the adviser has not retained the necessary supporting information as required by Rule 204-2. The adviser would, however, be required to retain whatever records it does have — *i.e.*, the recordkeeping requirement would apply to records in the adviser's possession as of the date it registers. This exemption applies only to the performance history of a private fund. An adviser would not be permitted to use performance results for managed accounts or any other performance information without complying with the requirements of Rule 204-2. This relief is available only to advisers that register after the effective date of the rule, and not to advisers that voluntarily register prior to that date.

The recordkeeping requirement would also be amended to specify that, for purposes of Section 204 of the Advisers Act, the books and records of an adviser include the records of any private funds for which such adviser acts as general partner, as managing member or in any similar capacity.

Limited Relief from Prohibition on Performance Fees

Registered investment advisers are generally prohibited from charging a performance fee to clients who are not "qualified clients." Qualified clients are generally investors, either individuals or companies, that invest at least $750,000 with an investment adviser or that have a net worth of $1.5 million. The proposed rule would "grandfather" from this requirement investors in a private fund that were investors before the adviser was required to register with the Commission. Absent this exemption, advisers to private funds would have to require investors that are not qualified clients to withdraw from the investment fund before the adviser registered under the Advisers Act, or forego charging those investors a performance fee.[5] Grandfathered investors would be permitted to add to their accounts, but not to open new investment accounts in the hedge fund or in other hedge funds managed by the same adviser. The proposal would grandfather only investors in private funds and not other investors in other advisory arrangements. This relief is available only to advisers that register after the effective date of the rule; it is not available to advisers that voluntarily register before that date.

The proposed rule would also effectively lock out potential hedge fund investors that are not qualified clients from making any new investments in hedge funds, since most hedge funds charge a performance fee. As a result, the rule will have the effect of reducing the perceived "retailization" of hedge funds, which is one of the reasons given for requiring hedge fund adviser registration.

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[5] Private investment funds exempted from investment company registration pursuant to Section 3(c)(7) of the Investment Company Act are not subject to the restriction on performance fees.

Offshore Advisers

Offshore advisers would be subject to the same look-through requirements and would be required to register only if they have more than 14 investors or other advisory clients that are U.S. residents. Nevertheless, offshore advisers to public funds that are regulated as public investment companies under the laws of a country other than the United States would not have to look through such public funds for the purpose of counting the number of U.S. clients they advise under Section 203(b)(3).

Offshore advisers to offshore hedge funds would also be permitted to treat the hedge funds, and not the investors in such funds, as their clients for all purposes of the Advisers Act other than the private adviser exemption and certain anti fraud provisions, provided that both the adviser and the fund have their principal offices and places of business outside the United States.[6] Such offshore advisers would therefore not be subject to any of the substantive requirements of the Advisers Act with respect to such offshore funds, including offshore funds that are owned exclusively by U.S. investors.[7] They would, however, be subject to the substantive Advisers Act requirements to the extent they have a direct U.S. advisory client.[8]

The proposed rule does not provide any exemption from the look-through requirement for situations where an investor in an offshore fund becomes a U.S. resident following his investment. Accordingly, it appears that an offshore adviser could inadvertently become subject to registration if more than 14 offshore fund investors relocate to the U.S. even though they were not U.S. residents at the time the initial investment was made.

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[6] The Commission has not articulated the circumstances under which a fund would be deemed to have its principal office and place of business outside the United States. In 1968, the Internal Revenue Service promulgated a regulation, the so-called "Ten Commandments," that listed ten, primarily formal, factors for determining whether an offshore fund would be considered to have its principal office in the United States. In 1997 the Code was revised so that a principal United States office was irrelevant and the regulation was repealed.

[7] The Commission has, however, requested comment on whether it should apply the substantive provisions of the Advisers Act with respect to offshore private funds owned primarily by U.S. residents.

[8] In the release, the Commission indicates that U.S. advisers will not be permitted to establish a non-U.S. shell subsidiary to manage offshore hedge funds, as that would violate Section 208(d) of the Advisers Act which prohibits any person from doing indirectly anything that would be unlawful for such person to do directly. Advisers with no affiliates, employees or other physical presence in the United States would presumably be able to rely on this exemption. It may be difficult, however, to apply this exemption to advisers with a more than a nominal presence in the United States.

Minimum Assets Under Management Requirement

The proposed rule would not alter the minimum assets under management required to register with the Commission. Accordingly, advisers with less than $25 million under management would continue not to be eligible for Commission registration. Such advisers may be required to register under applicable state law.[9] Advisers with between $25 and $30 million in assets under management would be eligible to register voluntarily with the Commission.

Expansion of Exemption from Custody Rule

The proposed rule would modify an exemption available to pooled investment vehicles under Rule 206(4)-2 (the "Custody Rule"). Currently, advisers to pooled investment vehicles (such as private funds) are not required to comply with the surprise audit and reporting requirements of the Custody Rule if they distribute audited financial statements prepared in accordance with generally accepted accounting principles to all fund investors within 120 days of the end of the investment vehicle's fiscal year. The proposed rule would extend the required delivery date to no later than 180 days after the end of the fiscal year.[10] This extension was designed principally for funds of hedge funds, which often are unable to meet the 120-day deadline because they cannot complete their financial statements until they receive financial statements from all the funds in which they were invested during the preceding year.[11]

To qualify for the exemption from the Custody Rule, the audited financial statements must be prepared in accordance with generally accepted accounting principles. The rule does not provide for any permissible exceptions or qualifications from generally accepted accounting principles. This would be of concern to funds that amortize their organizational costs over a period extending beyond their first year of operation. While not consistent with generally accepted accounting principles, that practice is common among hedge funds, and is arguably more equitable. The release does not address this issue.

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9 Investment advisers located in states with a *de minimis* exemption from investment adviser registration may be able to continue to rely on such exemption. While such states may follow the Commission's lead and rescind such exemptions, there may be a significant time-lag until that occurs. As noted below, however, the federal preemption of state adviser registration will be determined by looking through to investors.

10 The Commission stated in the release that until it takes action on this proposal, the Division of Investment Management will not recommend that the Commission take any enforcement action against an adviser to a fund of funds that acts in accordance with the proposed amendment. As proposed, the extension of the 120-day deadline to 180 days would apply to all private funds, but this temporary relief appears to apply only to funds of funds.

11 The Commission states it is soliciting comments on, among other things, whether to limit this 180-day period to funds of hedge funds and to continue to require other funds either to distribute their audited financial statements within 120 days or to comply with the Custody Rule.

State Registration Requirements

The proposed rule would have an apparently unintended effect on the availability of the exemption to federally registered advisers from state registration. Section 203A of the Advisers Act exempts a federally registered adviser from state registration while permitting a state to require the registration of an "investment adviser representative" working for a federally registered adviser that has a place of business in that state. Rule 203A-3 limits the definition of "investment adviser representative" to a supervised person of an investment adviser with more than five clients who are natural persons and not "qualified clients" and who represent more than ten percent of such supervised person's clients. Rule 203A-3 further provides that a supervised person may rely on Rule 203(b)(3)-1 for purposes of identifying his clients. As a result, supervised persons of an investment adviser managing a hedge fund are currently generally deemed to have fewer than five, and often no, clients who are natural persons.

Under the proposed rule, supervised persons of investment advisers managing hedge funds may lose the availability of the Section 203A exemption, depending on the number of investors in the fund that are not qualified clients. Thus, employees of hedge fund advisers, if they are based in a state that requires registration of investment adviser representatives (*e.g.*, Connecticut or New Jersey)[12] could become subject to the testing and other state requirements applicable to registered persons.

Another, apparently unintended, consequence would apply with respect to the availability of the *de minimis* exemption from state investment adviser registration for advisers not registered with the Commission. (Advisers registered with the Commission have the benefit of the preemption from state registration provided by Section 203A described above.) Section 222(d) of the Advisers Act prevents a state from requiring investment advisers to register with such state if the adviser does not have a place of business in such state and has fewer than six clients in such state during the preceding 12-month period. Rule 222-2 provides that, for purposes of Section 222(d), advisers may use the definition of "client" as set forth in Rule 203(b)(3)-1. Accordingly, hedge fund advisers generally are not subject to state-level registration in any state other than the state in which they are located because they do not have to look through the funds they advise for

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[12] For example, New Jersey's statute defines "investment adviser representative" to mean any person, including, but not limited to, a partner, officer, or director, or a person occupying a similar status or performing similar functions, or other individual, except clerical or ministerial personnel, who is employed by or associated with an investment adviser registered as an investment adviser in the State of New Jersey, or who has a place of business located in the State of New Jersey and is employed by or associated with a person registered or required to be registered as an investment adviser under the Advisers Act; and who does any of the following: (1) makes any recommendations or otherwise renders advice regarding securities if the person has direct advisory client contact; (2) manages accounts or portfolios of clients; (3) determines recommendations or advice regarding securities; (4) solicits, offers or negotiates for the sale of or sells investment advisory services; or (5) directly supervises any investment adviser representative or the supervisors of those investment adviser representatives.

purposes of counting the number of clients in any state. Absent a separate exemption for purposes of Rule 222-2, a hedge fund adviser not registered with the Commission would be required to review the registration requirements of any state in which there are six or more investors that are not “qualified clients” invested in a fund managed by such adviser to determine whether it is required to register in that state. This would be particularly burdensome to advisers of funds whose investors include funds of hedge funds or registered investment funds, because they would be required to count each investor in the “top-tier” fund as a client. In many instances, it may be impossible to obtain this information, particularly with respect to registered investment funds where investors may hold their interests in street name.

Compliance Date

The Commission has solicited comments on the date by which advisers to private funds must register and revise their policies and procedures to comply with Rule 206(4)-7, a recently adopted rule that currently requires all registered advisers by October 5, 2004 to have appointed a chief compliance officer and to have adopted written policies and procedures reasonably designed to prevent violations of the Advisers Act and the regulations thereunder by the adviser and its supervised persons.

Rationale for the Proposal

The release cites a number of reasons for the proposal, including:

- The growth of U.S. hedge funds. According to the Commission’s estimate, there are approximately 7,000 hedge funds with approximately $795 billion in assets.

- Growth in “hedge fund fraud.” In addition to the much-publicized “late trading” and inappropriate “market timing” practices, the release also cites instances of overstating performance, payment of unnecessary and undisclosed brokerage commission arrangements and misappropriation of client assets.

We note that, while advisers should review their valuation and “soft dollar” practices in light of the Commission’s focus on these issues, many of the instances of fraud cited by the Commission involved garden-variety fraud and do not necessarily indicate a Commission initiative to question accepted valuation and commission practices.[13]

- “Retailization” of hedge funds. The release notes the increased exposure of smaller investors, directly or indirectly, to hedge funds. This exposure can come by means of,

[13] While not listed as a type of fraudulent activity discovered by the Commission, the release notes that the Commission is also concerned that some hedge fund advisers may be pursuing strategies that are inconsistent with disclosures provided to investors.

> among other things, registered funds of hedge funds and increased investments by pension funds.[14]

The release also notes that the private adviser exemption (on which private fund advisers currently rely) was designed to cover only advisers with a small number of clients, not advisers with large numbers of clients who avoid registration by pooling client funds through a pooled investment vehicle rather than advising such clients directly. The Commission also notes (i) its lack of information about hedge fund advisers and (ii) the lack of a Commission oversight program that would permit the Commission to deter or detect fraud by unregistered hedge fund advisers at an early stage.

The Commission's assertion that the proposal is adequately justified by the need to protect investors departs from views the Commission has expressed previously. Of the several reasons cited by the release, only the "retailization" of hedge funds implicates the primary purpose of investment adviser regulation. In a 1992 report by the Commission's staff arguing against hedge fund regulation, which Commissioners Glassman and Atkins cite in their dissent, the staff observed that "the purpose of regulation is to protect investors, not to simplify investigations" and "the potential need to obtain information from hedge funds for enforcement purposes would not seem to be an adequate reason for registration."[15]

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[14] While not discussed outright, the release implicitly rejects regulating only the "retail" investors' direct exposure to hedge funds and opts instead to pursue regulation of the entire industry. As Commissioners Glassman and Atkins note in their dissent, registered funds of hedge funds already must be managed by a registered investment adviser and are subject to the requirements of the Investment Company Act. Similarly, pension plans are generally managed by a professional adviser which is subject to Department of Labor or state oversight.

[15] Section 201 of the Advisers Act does, however, cite transactions by investment advisers and their impact on the securities markets as one of the findings supporting the adoption of the Advisers Act.

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