



Regulatory Update — SEC Requires Registration of Hedge Fund Advisers

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Summary of SEC Release¹

A sharply divided Commission recently adopted rules that will require managers of hedge funds, defined by the Commission as “private funds”, to register as investment advisers under the Investment Advisers Act of 1940 (“Advisers Act”).² The rules are intended, in large part, to enable the Commission to obtain on a regular basis, through the Commission’s inspection program for investment advisers, more information concerning the operations, personnel, and activities of hedge funds. Support for these rules among the Commissioners was split along the same lines as that for the proposed rules on the same subject, with Chairman Donaldson and Commissioners Goldschmid and Campos voting in favor of adopting the rules and Commissioners Glassman and Atkins voting against their adoption and writing a vigorous dissenting opinion.

As adopted, the new rules and rule amendments will require managers of “private funds” to “look through” the funds they advise and to count the number of investors in those funds, as opposed to just the funds themselves, when determining whether they must register as investment advisers under the Advisers Act. Barring a successful court challenge (as one commenter threatened at the proposal stage, suggesting that the Commission lacked the authority to adopt the new rules), hedge fund managers will be required to register by February 1, 2006.

The New Rules

Section 203(b)(3) of the Advisers Act exempts from registration investment advisers with fewer than fifteen clients during the preceding twelve months that do not advise registered investment companies or business development companies and that do not hold themselves out generally to the public as investment advisers (“private investment adviser exemption”). Prior Rule 203(b)(3)-1 provided that a legal organization (such as partnership, trust or corporation) that receives investment advice based on its own objectives, rather than the individual investment objectives of its partners, beneficiaries or shareholders, is considered to be a single client for purposes of the private investment adviser exemption.³ Under the new rules, an adviser (including general partners of limited partnerships and managing members of limited liability companies) will no longer be able to consider certain entities — “private funds” — as single clients for purposes of the exemption.

In this regard, the Commission’s amendments to Rule 203(b)(3)-1 and its new rule, Rule 203(b)(3)-2, will now require an investment adviser to “look through” each

“private fund” it advises and count each owner (*i.e.*, each shareholder, limited partner, member or other security holder or beneficiary) of such fund as a client for purposes of determining the availability of the private investment adviser exemption. Similarly, advisers to hedge funds in which a registered investment company invests must count the investors in those registered funds as their own clients for purposes of the exemption.⁴ Hedge fund advisers located offshore must look through the funds that they manage, regardless of whether those funds are also located offshore, and count all investors that are U.S. residents, but not other offshore investors, as clients.⁵ As a result of these new rules, if, during the course of the preceding twelve months, a “private fund” had more than fourteen investors, the adviser to that fund would not qualify for the private investment adviser exemption.⁶ If it is adviser to more than one “private fund,” a hedge fund adviser will have to include all investors in each of the private funds that it advises, as well as any other advisory clients, in determining whether it meets the 14-client maximum to qualify for the exemption.

A “private fund” is defined as any company that: (i) would be an investment company but for the exceptions in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940;⁷ (ii) permits owners to redeem any portion of their ownership interests within two years of purchase; and (iii) interests in are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.⁸ A “private fund” does not include a company that has its principal office and place and business outside the U.S., makes a public offering of the securities outside the U.S., and is regulated as a public investment company of the laws of a country other than the U.S.

Because advisers that have not been registered likely would not have maintained the five years of records of past performance that registered advisers are required to maintain pursuant to Advisers Act Rule 204-2, the Commission has provided a safe harbor from violation of that rule with respect to past performance of both private funds and other accounts on a retroactive basis. Once a hedge fund manager has registered as an investment adviser, however, it must comply with the recordkeeping rule going forward. The Commission also amended Rule 204-2 to make clear that the books and records of the registered hedge fund adviser also would include records of the private funds for which the adviser acts as investment adviser as well as those of the adviser and any related person⁹ that acts as general partner, managing member or in a similar capacity. The Commission states that this is necessary because it believes that its examiners

need access to those records to determine whether the adviser is meeting its fiduciary obligations to the private fund under the Advisers Act and rules. Notably, this amendment gives the Commission examination authority not only over hedge fund advisers, but over the hedge funds themselves.

The new rules and rule amendments will restrict the ability of certain fund advisers to receive performance fees. Advisers Act Rule 205-3 permits an adviser to a fund that is exempt from registration under Section 3(c)(1) of the Investment Company Act to receive performance fees only if each investor in the fund is a “qualified client” — that is, the investor has a net worth of at least \$1.5 million or has at least \$750,000 of assets under management with the adviser. Because the amendments will expand the term “client” for advisors to private funds to include each of the investors in the funds, it is likely that certain advisors to private funds will no longer be able to receive performance fees under the Rule. As a consequence, to ameliorate this effect, the Commission added two grandfathering provisions to Rule 205-3 to permit hedge fund investors that do not meet the rule’s criteria for a “qualified client” from having to divest their current interests in such funds (because they otherwise would disqualify the fund from being able to continue to pay performance fees). Under these provisions, existing owners in any fund exempt from registration under Section 3(c)(1), even if they are not qualified clients, may retain their existing investments and add to them, but they may not open new accounts in that or any other hedge fund).¹⁰ Further, newly-registered hedge fund advisers will be able to keep their current advisory contracts with other clients that are not Section 3(c)(1) funds even though those contracts call for the payment of performance fees.

The Commission also has amended Rule 206(4)-2, the investment adviser custody rule, to accommodate managers of funds of hedge funds. Under the prior rule, an adviser acting as general partner to a pooled investment vehicle, including a hedge fund, has been deemed to have custody of the pool’s assets, and therefore has had to deliver custody account information to investors. An adviser to a fund could comply with this requirement by distributing the fund’s audited financial statements to investors within 120 days of the fund’s fiscal year end.¹¹ Because the underlying funds in a fund of funds can take up to 120 days to conclude their own audits, it would be impractical for the adviser to such funds of funds to complete their own audits within the 120-day limitation. For this reason, the Commission extended the period in which custody account information (*i.e.*, audited financial

statements) must be distributed for funds of funds to 180 days.

Reasons Given in the Adopting Release For Adoption of the New Rules

The Adopting Release states that the new rules are needed because the Commission’s current regulatory program for hedge fund managers is “inadequate” in light of “the growth of hedge funds, the broadening exposure of investors to hedge fund risk, and the growing number of instances of malfeasance by hedge fund advisers.”¹² Those rules, the release states, will enable the Commission to deter and detect frauds by hedge fund managers before they occur (or have been completed) and thus will prevent losses of investors’ assets that otherwise would result from such fraudulent conduct. Requiring hedge fund managers to register and develop compliance infrastructures and subjecting them to examinations, in the view of the Commission, will not subject those managers to “undue burdens” or “interfere significantly with their operations.”¹³ The Commission points to the fact that many managers of hedge funds are already registered as investment advisers today to support that conclusion. The following considerations, among others, are listed as reasons that support the need for the new rules:

- Census Information. Registration provides the Commission with the ability to collect data from registered hedge fund advisers (*e.g.*, the number of hedge funds managed by advisers, the amount of assets in hedge funds, the number of employees and types of other clients these advisers have, other business activities they conduct, and the identity of persons that control or are affiliated with the firm).
- Deterrence of Fraud. Registration enables the Commission to conduct examinations of hedge fund advisers that will permit Commission staff to identify compliance problems at an early stage, identify practices that may be harmful for investors (*e.g.*, problems in valuing client assets or allocating trades), and provide a deterrent to unlawful conduct (because the risk of getting caught is increased).
- Keeping Unfit Persons From Using Hedge Funds to Perpetrate Frauds. Registration will allow the Commission to review the qualifications of individuals associated with advisers to hedge funds and deny registration of those persons subject to statutory disqualifications (*e.g.*, persons with felony convictions or who have been subject to prior disciplinary action).

- Adoption of Compliance Controls. The requirement that registered investment advisers, including advisers to hedge funds, adopt policies and procedures designed to prevent violation of the Advisers Act and to designate a chief compliance officer will supplement the Commission's examination and enforcement programs.
- Limitation on Retailization. Because most hedge fund advisers charge performance fees, registration will result in all direct investors in most hedge funds meeting the minimum standards of Advisers Act Rule 205-3, which requires that each investor in a private investment company that pays a performance fee generally have a net worth of \$1.5 million or have at least \$750,000 of assets under management with the adviser. This will presumably prevent the "retailization" of hedge funds and the marketing of such funds to unsophisticated investors.
- CFTC Regulation Not Sufficient. The Commission rejected, as inconsistent with functional regulation, the argument that subjecting hedge fund managers who already are registered as commodity pool operators or commodity trading advisers (and thus are subject to CFTC oversight) to additional Commission oversight would be duplicative. In this regard, the Commission noted that the statutory exemption in the Advisers Act from registration for any CFTC-registered commodity trading advisor only applies if its business does not consist primarily of acting as an investment adviser.

The Commission further states that adoption of Rule 203(b)(3)-2 aligns the Commission's rules more closely with Congress' original intent in adopting the private investment adviser exemption because, while that exemption as heretofore construed permitted unregistered advisers to manage large amounts of money for potentially hundreds of investors (at least on an indirect basis), the exemption was intended only to exempt advisers "whose business activities are too limited to warrant federal attention."¹⁴

The Dissenting View

In their written dissent to the adopting release, Commissioners Glassman and Atkins repeated many of the same arguments they had put forth in their dissent to the proposing release for this rulemaking. While they agree that the Commission needs more information on hedge funds, they continue to disagree that the majority's solution is the right way to achieve that goal. They perceive three main shortcomings with respect to the adopted rules: (1) there are many viable alternatives to the rulemaking that should have been considered; (2) the reasons given by the Commission for adoption of the new rules do not withstand scrutiny; and (3) the Commission's limited resources will be diverted unnecessarily.¹⁵

Endnotes

¹ This paper is intended as a brief description of recent action by the Securities and Exchange Commission (“Commission”) and not as legal advice.

² See Investment Advisers Act Release No. 2333 (Dec. 2, 2004), 69 FR 72054 (Dec. 10, 2004) (“Adopting Release”), available on the Commission’s Web site at <http://www.sec.gov/rules/final/ia-2333.htm>. The six-week period between the Commission’s vote to adopt these rules on October 26, 2004 and the publication of the Adopting Release likely resulted from the inclusion of an extensive dissenting opinion from Commissioners Glassman and Atkins.

³ As a result, for example, a general partner of a limited partnership as a collective investment vehicle for its limited partners has not had to register as an investment adviser under the Advisers Act regardless of the number of limited partners involved or the amount of assets in the partnership managed by that general partner, unless that general partner otherwise lost its ability to rely on Section 203(b)(3) (e.g., by holding itself out generally to the public as an investment adviser).

⁴ See Rule 203(b)(3)-2(b). As a result, it is likely that any hedge fund in which a registered investment company is an investor would necessarily exceed the 14-client limit of the private investment adviser exemption. Thus, all advisers to hedge funds in which a fund of funds invests are likely to be subject to registration under the Advisers Act.

⁵ If an investor in a private fund is a non-U.S. client at the time of investment, but later re-locates to the U.S., the offshore adviser may nevertheless continue to count that investor as a non-U.S. client for purposes of the exemption. Furthermore, although an offshore adviser may be required to register if it has the requisite number of U.S. resident clients, a hedge fund adviser located offshore is nevertheless permitted to treat a private fund that is organized or incorporated under the laws of a country other than the U.S. as its client for most purposes under the Advisers Act pursuant to Rule 203(b)(3)-2(c). This means that while the offshore adviser may, unless another exemption applies, be required to register and keep the requisite books and records and be subject to Commission examination, it would not be subject to rules relating to custody, proxy voting, and codes of ethics, among others.

⁶ The adviser is not, however, required to count either itself or certain adviser insiders as clients if they own interests in the private funds.

⁷ Section 3(c)(1) exempts issuers whose outstanding securities are beneficially owned by 100 or fewer persons and that are not making and do not presently propose to make a public offering of their securities, while Section 3(c)(7) exempts those issuers whose outstanding securities are owned exclusively by persons who were qualified purchasers at the time of acquisition and that are not making and do not at that time propose to make a public offering of their securities.

⁸ See Rule 203(b)(3)-1(d).

⁹ This requirement is intended to encompass any special purpose vehicle named as the hedge fund’s general partner.

¹⁰ This precludes hedge fund advisers that now charge performance fees from accepting new investors in the funds who are not qualified clients unless those fee structures are changed.

¹¹ See Advisers Act Rule 206(4)-2(b)(3).

¹² Adopting Release, 69 FR at 72059. In fact, the majority rejected all of the commenters’ various suggested alternatives to registration of hedge fund advisers as only partial responses to the Commission’s concerns and because anything short of registration would not permit Commission examination of hedge fund adviser activities. *Id.* at 72066.

¹³ *Id.*

¹⁴ *Id.* at 72065 -72066.

¹⁵ See 69 FR at 72089-90.

For Further Information

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