Ongoing Compliance Updates for Investment Advisers

Compliance Review

SEC Proposes Investment Adviser Registration of Hedge Fund Managers

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On July 20, 2004, the SEC proposed a new rule and rule amendments that, if adopted, would require most investment advisers that manage more than $25,000,000 and manage "private funds" to register as investment advisers with the SEC.[1]

Proposed Rule.

Under Advisers Act section 203(b)(3), an investment adviser generally is not required to register if it (1) has had fewer than fifteen clients during the preceding twelve months and (2) does not hold itself out generally to the public as an investment adviser. Advisers Act Rule 203(b)(3)-1 currently permits an investment adviser to count each hedge fund it manages as a single "client" for these purposes. If adopted, the proposed rule would modify the current rule to require an investment adviser to count as a client each investor of any "private fund" it manages. The adviser would also be required to look through a private fund to the owners of any other private fund or any investment company registered under the Investment Company Act of 1940 (a so-called "mutual fund") that has invested in the private fund that the adviser manages.

Any investment adviser that manages more than $25,000,000[2] and has more than 14 clients, counting each separate account client and each investor in a "private fund," would be required to register with the SEC as an investment adviser, whether that adviser currently is unregistered or registered as an investment adviser with a state securities authority or as a commodity trading adviser of commodity pool operators with the Commodity Futures Trading Commission. Investment advisers with less than $25,000,000 of assets under management remain subject to regulation of investment advisers under state law.

Definition of "Private Fund."

The proposed rule defines a "private fund" as an entity (1) that would be an "investment company" under the Investment Company Act but for the exception provided from that definition by section 3(c)(1) or 3(c)(7) of that Act; (2) that permits its owners to redeem any portion of their ownership interests in the fund within two years of purchasing those interests;[3] and (3) whose interests are offered based on the ongoing investment advisory skills, ability or expertise of the investment adviser.

The definition was designed to include "traditional" hedge funds but exclude venture capital funds, private equity funds and other investment pools that are not "traditional" hedge funds. An offshore hedge fund likely would also be considered a private fund[4] and each investor in that fund (whether a U.S. or non-U.S. investor) likely would be counted toward the adviser's 14 client limit.

Proposed Rule Amendments.

The SEC also proposed several related Advisers Act rule amendments.

- Rule 204-2 requires an SEC-registered investment adviser to keep records that support its performance advertisements. To allow an investment adviser to continue to market a private fund's performance, Rule 204-2 would be amended to require investment advisers that were not SEC-registered before the proposed rule's effective date to preserve any records demonstrating the performance of any private fund, but would not require that those records otherwise meet the books and records retention requirements of Rule 204-2.
- Rule 204-2 also would be amended to require that the books and records of an SEC-registered investment adviser include the books and records of a private fund for which it acts as the general partner, managing member or in a comparable capacity.
- Rule 205-3 allows an SEC-registered investment adviser to charge a performance fee or allocation only to a "qualified client" (generally, an investor with a net worth of $1,500,000, an investor with at least $750,000 under the investment adviser's management, a non-U.S. investor, a qualified purchaser for purposes of Investment Company Act section 3(c)(7) or one of several specified managers or employees of the investment adviser). To avoid requiring investors in private funds to divest their interests in those funds, Rule 205-3 would be amended to allow an investment adviser to continue to charge a performance fee or allocation to an investor that invested in a private fund prior to the proposed rule's effective date, even if that investor is not a qualified client.
- Schedule D of Form ADV would be amended to require an adviser to identify and provide other information about each private fund it manages, similar to the information that Schedule D currently requires with respect to any entity of which the adviser or its related person is a general partner or manager. Many advisers already disclose U.S.-based hedge funds they manage on Schedule D, but one effect of the proposed rule amendment would be to require the adviser to identify offshore hedge funds to which the adviser acts solely as an investment adviser (and not general partner or manager).

Background of the Proposal.

The SEC's proposal implements the SEC staff's recommendations in a September 2003 report, which was the culmination of the SEC staff investigation of hedge funds. In the proposing release, the SEC cited five principal reasons for the proposal: (1) collection of necessary data regarding private funds and their advisers; (2) deterrence and early detection of fraud; (3) ability to prevent unfit persons from managing private funds; (4) adoption of compliance controls for the protection of investors; and (5) discouraging "retailization" of hedge funds by requiring that each investor in a private fund be a qualified client.

The SEC voted three to two to propose the rule and the two opponents dissented in writing. Most commentators do not object to the proposal to gather more information regarding the hedge fund industry. The Commissioners' dissent and objections raised by public officials (Alan Greenspan among them), and in comments submitted to the SEC, generally make some or all of the following objections: (1) that the proposed rule will not elicit useful information; (2) that evidence does not support an argument that disproportionate fraudulent activity occurs among hedge funds; (3) that SEC registration is unlikely to detect or deter fraudulent activity, given the infrequency of SEC examinations; (4) that the cost of additional SEC resources and expertise to regulate the additional 700 to 1,200 private fund advisers that the SEC staff has estimated would be required to register is outweighed by the unproven benefit of regulation, especially given the relative sophistication of the investors in those private funds; (5) that registration does not involve determination whether an investment adviser is unfit; and (6) that the evidence of significant "retailization" is, at best, sparse.

The comment period ended on September 15, 2004, and the SEC refused several requests to extend it. The SEC could vote on it within the next month. If the proposed rule is approved in its current form, it would become effective six months from approval.

Other Implications of SEC Registration.

If the proposed rule is adopted, investment advisers to private funds that currently are not SEC-registered will become subject to a number of significant requirements:

Form ADV. Advisers that currently are not required to file a Form ADV would need to complete the Form and offer to distribute Part II to current and future investors in their hedge funds (and to separate account clients). Form ADV, including the recently amended Part I, was not designed with hedge fund advisers in mind, and many of its questions create frustrating, if not fascinating, imponderables in the hedge fund context. The SEC has so far deferred action on its announced intention to consider overhauling Part II of Form ADV, but even that process may not address the relevant issues and may result in substantially greater burden in completing and updating the Form.

Custody Rule. SEC-registered advisers must maintain each hedge fund's assets (and the assets of the adviser's other clients) with a qualified custodian and notify the fund's investors where those assets are held. Unless the hedge fund distributes annual financial statements audited in accordance with GAAP within 120 days of the end of the fund's fiscal year, an SEC-registered adviser must also arrange for the fund's account statements to be sent to the fund's investors. The proposed rule amendments also include an unrelated proposal to allow the manager of a fund of hedge funds to distribute those audited financial statements within 180 days of the end of the fiscal year of the fund of hedge funds. Until the proposed rule is effective, the SEC will allow any fund of hedge funds (but not a hedge fund itself) to take advantage of the extended period. State-registered or unregistered advisers that currently follow the *Bennett* and *PIMS* line of SEC no-action letters may no longer rely on those letters to avoid the custody rule if they become SEC-registered.

Policies and Procedures. The SEC has promulgated numerous rules that require advisers to maintain specific policies and procedures regarding, among other things, prevention of insider trading, privacy, proxy voting, compliance programs and codes of ethics. SEC-registered investment advisers must adopt and implement policies and procedures that address, at a minimum, all of the following issues and must have a chief compliance officer who oversees those policies and procedures:

- A code of ethics designed to prevent fraud by firm personnel, which also addresses the firm's standard of business conduct, compliance with federal securities laws (which may include a fairly extensive discussion of the specific laws, rules and regulations applicable to the adviser, its employees and any funds it manages), personal securities reporting, pre-approval of certain transactions and reporting of violations of the code of ethics;
- Prevention of insider trading;
- Proxy voting;
- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser and applicable regulatory restrictions;
- Trading practices, including procedures by which the adviser satisfies its best execution obligation, use client brokerage to obtain research and other services and allocate aggregated trades among clients;
- Proprietary trading of the adviser and personal trading activities of supervised persons;
- The accuracy of disclosures made to investors, clients and regulatory authorities, including account statements, advertisements and published prior performance;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- Marketing practices, including the use of solicitors;
- Procedures to value client holdings and assess fees based on those valuations;
- Safeguards to protect the privacy of client records and information; and
- Business continuity plans to protect client interests if the adviser becomes unable to provide advisory services (for example, after a natural disaster).

Recordkeeping Requirements. SEC-registered advisers must keep myriad financial, trading, marketing and client relations, policies and procedures and general records, in most cases, for at least five years and in some cases indefinitely.

SEC Examinations. SEC examinations are typically conducted by sophisticated and knowledgeable inspectors over a number of days or weeks. Based on SEC staff reports, speeches by SEC staff and SEC staff examination requests, the SEC staff is familiar with and likely to scrutinize some or all of the following hot-button issues: (1) soft dollar practices, especially those that do not meet the safe harbor provided by Exchange Act section 28(e); (2) best execution, including whether the investment adviser periodically reviews execution quality and cost and then documents that review; (3) trade allocation policies and practices, including whether the adviser delays allocating trades among the adviser's accounts, discriminates among clients (for example, by allocating new issues to accounts that pay the adviser a performance allocation) or misappropriates client opportunities; (4) trade error policies and practices, to ensure that advisers correct errors rapidly, do not use client assets (including soft dollars) to correct trading errors and do not discriminate among clients (for example, a client with better performance should not be allocated an error); (5) performance advertising policies, practices and documentation; and (6) valuation policies and procedures.

Marketing and Past Performance Disclosure. SEC-registered advisers are subject to several rules and a number of interpretations that regulate their marketing and disclosure of their past performance.

Some Significant Benefits. SEC registration does have significant benefits:

- **Publicity.** Unlike an adviser that is not registered with the SEC or a state, an SEC-registered adviser can hold itself out to the public as an investment adviser. Public offerings of an adviser's hedge funds are still prohibited unless the funds themselves are registered with the SEC. It is not yet clear whether SEC registration, which includes disclosure that an investment adviser manages a hedge fund and information about the hedge fund, would constitute a form of general solicitation or advertising, precluding reliance on the private offering exemption, which is an essential element of reliance on the Investment Company Act sections 3(c)(1) and 3(c)(7) exceptions from the definition of "investment company."
- **Appeal to ERISA Investors.** Some larger ERISA plans might be more likely to invest in hedge funds managed by SEC-registered or state-registered advisers, because trustees of ERISA plans may be exempt from co-fiduciary liability for acts or omissions of such advisers, if certain conditions are met.
- **Short-Swing Profits.** An SEC-registered adviser may be able to exclude assets held in a client account (such as a hedge fund) from its own holdings for purposes of determining whether it has 10% beneficial ownership of an issuer's class of securities under Securities Exchange Act section 16.

About the Authors.

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[1] Advisers Act Release No. 2266 (July 20, 2004). A copy of the proposing release, the dissent by two SEC commissioners and public comments are available at www.sec.gov/rules/proposed.shtml.

[2] The current rule that prohibits investment advisers with less than $25,000,000 of assets under management from registering with the SEC would remain unchanged.

[3] A fund would be deemed to meet this two-year ownership requirement if it allows owners to redeem their interests within two years of investment only in case of (1) extraordinary and unforeseeable events at the time of investment or (2) interests acquired with reinvested dividends.

[4] The proposed rule excludes from the definition of "private fund" a fund that (1) has its principal office and place of business outside the U.S. and (2) makes a public offering of its securities in a country other than the U.S. and is regulated as a public investment company by that country.