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Client Memorandum

Investment Management

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A Recap of the SEC Hedge Fund Roundtable

After spending two days sitting in on the SEC Hedge Fund Roundtable, all we can say for certain is that something is going to change – what exactly the change (or changes) will be is still unclear. While we doubt there will be wholesale changes to our industry, we do think there will be at least a handful of significant changes considered, and possibly even proposed and adopted.

The one change we are almost certain will be proposed is to adjust the "accredited investor" standard for individuals who wish to invest in hedge funds. The specifics of the new standard are unknown, but one SEC staffer who spoke at the Roundtable indicated that he'd like to see the current thresholds (generally, $200,000 in annual gross income or $1 million in net worth) doubled. While this may pose a problem for many smaller, start-up hedge fund managers trying to get their funds off of the ground, it is arguably appropriate in light of the fact that the current standard for individual accredited investors hasn't been changed in 20 years.

Another idea that was discussed was making every hedge fund manager register as an investment adviser at the federal level. Currently, many hedge fund managers are exempt from registration under the Investment Advisers Act (the "Advisers Act") because they are able to rely on the exemption from registration provided by Section 203(b)(3) of the Advisers Act. Under Section 203(b)(3), a manager is not required to register as an investment adviser at the federal level if it has 14 or fewer clients in any given twelve month period and does not hold itself out generally to the public as an investment adviser. There is also a rule under the Advisers Act that allows a manager to treat a fund as a single advisory client, rather than requiring a manager to "look through" the fund and counting each investor in the fund as an advisory client. The repeal of this rule would mean that a manager that is currently exempt from registration under Section 203(b)(3) would have to look through all of its funds and count the investors in the funds as advisory clients. If the number of investors should hit 15 or more, the manager would be required to register.

At present, however, even if a manager has 15 or more clients, it is not eligible to register unless it has at least $25 million in assets under management, and is not required to register unless it has $30 million or more under management. So, even if the SEC repealed the rule that allows a manager to treat a fund as a single client, it would also need to convince Congress to change the Advisers Act if it sought to have every hedge fund manager – regardless of the size of its assets under management – register at the federal level. Notwithstanding the $25 million threshold for federal registration, the state securities commissioners have been campaigning to have every state adopt the most recently-drafted model securities legislation that has effectively repealed the *de minimis* exemption for investment advisers at the state level (many states currently exempt from registration investment advisers that have 5 or fewer clients in any 12 month period and that don't hold themselves out to the public as investment advisers). If the SEC were to repeal the "fund as a single client" rule at the federal level, the state securities commissioners would likely have a stronger argument in getting their respective legislatures to adopt the revised model legislation.

These two possibilities are the two most likely changes to the day-to-day regulatory oversight of hedge funds. But there were a few other ideas floated that may resurface as proposed changes.

There is a possibility that the SEC will require *all* hedge funds offered in the U.S. to retain 3rd party "administrators." Several comments were made as to how offshore funds generally have 3rd party administrators and how that fact provides additional checks and balances on the managers of offshore hedge funds. Whether having a 3rd party administrator really provides any checks and balances is open to debate, but the SEC Commissioners seem to think they do.

Another possibility is that the SEC will mandate certain information that must be included in a hedge fund's offering materials. No specifics were suggested, but the implication is that current hedge fund disclosure was not sufficient for investors to make a reasonable investment decision. We personally don't think this alternative will go anywhere, for the simple reason that is it based on a lack of information. Any person with the vaguest familiarity with hedge funds knows that hedge fund offering documents typically contain risk disclosure language that dwarfs the type of risk disclosure language contained in, say, the typical mutual fund prospectus.

Finally (and, in our view, surprisingly), there was a lot of discussion at the Roundtable about finding ways to give the general investing public access to hedge funds, or at least to hedged strategies. Several of the Commissioners made comments that if hedge funds truly were safer from an investment risk perspective (a statistic from one of the Roundtable participants indicated that an average hedge fund had 50% of the volatility of the S & P 500, and an average fund of funds had 25%), then we should find a way to give these alternatives to the general investing public. There were two ideas floated for making this happen – allowing hedge funds to be sold to the public and loosening the investment restrictions on mutual funds. At this point, we have no informed opinion as to whether either or both are viable, but the hedge fund managers and consultants at the Roundtable all agreed that the general investing public should not be investing in hedge funds as they are today.

On a related matter, the SEC Commissioners and staffers clearly indicated that they are considering loosening the restrictions on how "privately offered" securities can be sold. Between the Internet and the financial press, information about "privately offered" securities is far more available than Regulation D was intended to deal with. Moreover, they seemed to agree that more information was better than less and that allowing hedge fund managers to publicly discuss their funds would ameliorate the current problem of second-hand information being fed to the public. To address this issue, we think we will likely see a rewrite of Regulation D that allows for general "solicitation" for privately offered securities as long as they are "sold" privately–in other words, only to qualified investors. The one trade off this might entail is that issuers of private securities may no longer be able to rely on a reasonable belief standard for accepting qualified investors, i.e., instead of relying on representations and warranties from investors regarding their accredited status, managers may be required to conduct a great deal of "due diligence" to make sure that those representations and warranties are correct.

At the close of the Roundtable, SEC Chairman Donaldson asked the SEC staff to prepare a report based on its investigation and the Roundtable that addresses the risks of the hedge fund industry and possible regulatory solutions to those risks. When that report is issued, we will have a better idea of what exactly the SEC is thinking.

If you have any questions or concerns regarding the SEC's attention to our industry, don't hesitate to call any of the attorneys in our Investment Management group – we would be happy to help you work through any concerns you have.

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