How the Proposed SEC Regulations Would Affect Hedge Fund Managers

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On July 14, 2004, the SEC voted 3-2 to propose rules that, if adopted, would require many hedge fund managers to register with the SEC as investment advisers under the Investment Advisers Act of 1940, as amended (the “IAA”). The rules would generally apply to managers with 15 or more investors and at least $25 million in assets under management (although SEC registration would be optional for managers with between $25 and $30 million under management).

Registration as an IA would impose new burdens and restrictions, the impact of which will depend on the size, structure and investor base of the fund or funds a manager advises. Primary burdens for hedge fund managers of adviser registration would be: (1) adoption of compliance policies and procedures and approval of a chief compliance officer; (2) limitations on fees; (3) books and records requirements; and (4) SEC inspections. However, registration offers hedge fund managers several potential advantages. Registered advisers are less restricted in their ability to advertise their advisory business. They also can structure their funds to more particularly meet the needs of investors without worrying about their numbers of funds or clients.

Managers With $30 Million of Assets Under Management Required to Register With the SEC

As a general matter, IAs with $30 million or more in assets under management must register with the SEC. Those with between $25 million and $30 million may register with the SEC but are not required to do so. The states have exclusive jurisdiction over IAs with less than $25 million under management. Therefore, any changes brought about by the SEC’s rule proposal will likely chiefly impact IAs with $30 million or more under management. However, many managers with between $25 and $30 million under management may choose to register with the SEC because, among other reasons, applicable state registration exemptions may no longer be available. At this time, it is unclear whether state securities administrators will require registration of hedge fund managers with less than $25 million of assets under management.

Ability to Rely on 15 Client De Minimis Exemption Restricted by New “Look Through Provision”

Under current SEC rules, there are several exemptions from IA registration. The exemption relied on most often by hedge fund managers is the so-called de minimis exemption. This exemption, found in Section 203(b)(3) of the IAA, exempts an IA from registration if it has had fewer than 15 clients during the preceding 12 months, does not advise any registered investment companies or companies electing to be regulated as business development companies, and does not hold itself out to the public as an investment adviser. Current Rule 203(b)(3)-1 provides, among other things, that a corporation, general or limited partnership, limited liability company, or other legal organization that receives investment advice based on its investment objectives (as opposed to the investment objectives of its individual shareholders, partners or limited partners) is counted as a single client. Therefore, under the current rules, any fund manager that advises no more than 14 hedge funds generally does not have to register with
the SEC as an investment adviser. The SEC’s proposal would amend Rule 203(b)(3)-1 by adding a provision stating that managers of “private funds”\(^1\) may not rely on the rule with respect to those funds. The effect of this change would be to require an adviser to “look through” the hedge fund entity and count individual investors as clients for purposes of determining whether they have 15 clients. Specifically, proposed Rule 203(b)(3)-2 would provide that managers “must count the shareholders, limited partners, members, other securityholders or beneficiaries . . . of a private fund as clients.” Additionally, the proposed rule would provide that if a private fund has investors that are registered investment companies (such as “registered fund of funds”), it must look through and count the number of investors in such registered investment companies.

**Offshore Advisers Must Count U.S. Investors in Offshore Funds**

As proposed, the rules would require offshore advisers of private funds to look through those funds and count any U.S. investors for purposes of determining whether they have 15 or more clients. Of note, the $25 million registration threshold does not apply to offshore advisers, so even small offshore advisers of funds with at least 15 U.S. investors would be required to register with the SEC. However, the proposal would exempt offshore advisers from counting the U.S. investors in publicly offered funds regulated as public investment companies in countries other than the U.S. Additionally, offshore advisers to offshore funds required to register pursuant to these rules would be subject only to the anti-fraud provisions of the IAA with respect to those offshore funds and other offshore clients.

**Adoption of Compliance Controls**

One of the primary concerns regarding SEC registration for hedge fund managers will be the IAA’s requirements for IAs to have written compliance policies and procedures and a chief compliance officer to administer them. Under recently adopted rules, SEC-registered IAs must adopt and implement written policies and procedures reasonably designed to prevent violations of the IAA by the IA or any of its supervised persons. The policies and procedures should be designed: (1) to prevent violations from occurring; (2) to detect violations that have occurred; and (3) to correct promptly any violations that have occurred. Under the rule, IAs are required annually to review their policies and procedures for adequacy and effectiveness. An IA must designate a chief compliance officer to administer its compliance policies and procedures. IAs

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\(^1\) The proposed rule would define a private fund as a company: that would be an “investment company” under the Investment Company Act of 1940, as amended (the “1940 Act”), but for the exceptions from that definition provided by either section 3(c)(1) or 3(c)(7) of the 1940 Act; that permits its owners to redeem any portion of their ownership interests within two years of purchase (other than due to unforeseeable circumstances or in the case of interests acquired with reinvested dividends); and interests of which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser. This definition is intended to exclude other types of private funds such as venture capital and private equity funds.
are also required to adopt standards of conduct expected of advisory personnel for personal trading.

**Limitations on Fees**

Another chief concern for hedge fund managers of SEC registration will be the IAA’s restrictions on performance fees. While the IAA permits a performance fee to be charged to a 3(c)(7) or “qualified purchaser” fund, a registered adviser to a 3(c)(1) or “100 person” fund can charge a performance fee only to investors in the fund that are “qualified clients.” Qualified clients are generally natural persons or companies that have either: (1) at least $750,000 under management with the adviser immediately after entering into the contract; (2) a net worth at the time of entering into the contract of $1.5 million; or (3) are qualified purchasers. Executives, trustees, directors, general partners and certain advisory employees are also considered qualified clients. The proposed rules contain a “grandfather provision” that would allow managers of private funds currently relying on the *de minimis* exemption from registration to continue to charge performance fees to investors that are not qualified clients if they were already investors at the time the rule goes into effect. Managers would also be permitted to accept subscriptions from new investors that are not qualified clients, although such investors could not be charged performance fees.

**Books and Records Requirements**

Registered IAs are required to maintain extensive books and records. This requirement is found in Rule 204-2 under the IAA. All of these required records must generally be kept in an easily accessible place for five years, the first two in the adviser’s office. The Rule requires advisers to maintain, among other things:

- A journal or journals, and any other records of original entry forming the basis of entries in any ledger;
- General and auxiliary ledgers reflecting assets, liability, reserve, capital, income and expense accounts;
- A memorandum of each order given for a security transaction, any instructions received from clients concerning the purchase or sale of a security, and any modification or cancellation of such order or instruction;
- Check books, bank statements, cancelled checks and cash reconciliations;
- All bills or statements relating to the business of the investment adviser;
- All trial balances, financial statements, and internal audit working papers relating to the business of the IA;
- Written communications received or sent by the adviser relating to any recommendation made or proposed to be made and any advice given or proposed to be given, any receipt, disbursement or delivery of funds or securities, or the placing or execution of any order to purchase or sell any security;
- A list of all discretionary accounts of the IA;
- All powers of attorney;
• All advisory agreements;
• All advertisements;
• All personal security transactions of the IA and any advisory representatives;
• All internal working papers and any other documents necessary to form the basis for performance calculations used in advertisements or other communications; and
• A record of proxy votes by the IA.

Rule 204-2 would be amended to make clear that the books and records requirements will apply to the records of private funds for which a registered hedge fund manager, or its affiliate, acts as a general partner, managing member or in a similar capacity. In addition, as noted above, Rule 204-2 requires IAs to maintain internal working papers and any other documents necessary to form the basis for performance calculations used in advertisements or other communications. The SEC has recognized that many hedge fund managers may not have retained these records for past performance periods. The proposal would exempt managers from the recordkeeping requirements for books and records pertaining to the performance of a hedge fund for any period ended prior to the effective date of the rule. In order to rely on this exemption, a manager must not have been registered with the SEC at any point during the advertised period and must preserve any books and records in the manager’s possession that pertain to performance for such period.

SEC Inspections

Section 204 of the IAA gives the SEC the power to inspect registered IAs. The SEC does not need to allege a wrongdoing in order to inspect an IA. Inspections are a regular occurrence for registered IAs (although the SEC can conduct an inspection for cause when it suspects a violation). Inspections are generally conducted on a surprise basis. When the SEC inspects an IA, it will review the books and records detailed above as well as examine the adviser for general compliance with the IAA and other securities laws. The SEC will also check to make sure that the IA’s practices are consistent with its disclosures in its disclosure document (Form ADV).

Other Registration Concerns

If the SEC requires hedge fund managers to register, those managers will have to complete a Form ADV. Form ADV consists of two parts. Part I is filed with the SEC and is aimed at providing information to regulators for use in, among other things, the IA examinations discussed above. Part II of Form ADV is for delivery to clients and describes various aspects of the IA’s business such as services, fees, types of clients and investments, and other business activities and practices. An IA must deliver to an advisory client or prospective advisory client a written document containing at least the information required in Part II of Form ADV (a "brochure") at least 48 hours before entering into an advisory agreement (or at the time of entering into the agreement if the agreement is terminable without penalty by the client within five days of entering into it). The IA must also annually in writing offer to deliver a brochure, without charge, and the brochure must be mailed or delivered within seven days of receipt of a
request. The proposed rules would slightly modify Form ADV to provide for specific information about hedge funds.

Other Considerations

Under the SEC’s custody rules, an SEC-registered hedge fund manager generally must deliver GAAP audited financial statements to investors within 120 days of the fund’s fiscal year-end. This creates difficulties for advisers to unregistered fund of funds, which must wait for underlying fund financials before completing their audits. In response, the SEC is proposing to extend this 120-day period to 180 days (for all hedge funds, not only fund of funds). Importantly, a footnote to the release notes that fund of funds may immediately begin relying on this extension while the SEC considers adopting a final rule.

There are other burdens and requirements related to SEC registration. These include, without limitation: (1) specific requirements as to advisory contracts; (2) restrictions on the ability to make principal transactions and agency cross trades and to pay solicitation fees; and (3) supervisory duties.

Registration also provides managers with some advantages. Most notably, a registered investment adviser can hold itself out to the public as such. As discussed above, the de minimis exemption requires that the manager not hold itself out to the public as an IA. The SEC has interpreted this restriction broadly, prohibiting, for example, exempt IAs from listing themselves as IAs (or the functional equivalent thereof) in phone books or business directories. Registering with the SEC will allow managers to freely hold themselves out as advisers. (However, IAs must still be careful not to advertise their hedge funds in violation of the “general solicitation” restrictions on private placements.)

Registering as an IA would also allow hedge fund managers greater structural flexibility. Unregistered advisers may find themselves structuring their funds or turning away potential clients because of the 14 client limit of the de minimis exemption. Registering would allow IAs to structure products for particular clients through separate accounts, funds, sidepockets, etc.

There has been a great deal of opposition to requiring hedge fund managers to register with the SEC. Comments on the proposed rules were due on September 15, 2004. If adopted, the SEC has indicated managers will likely have about six months to comply.
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