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Client Alert

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SEC Staff Report Recommending Registration of Hedge Fund Managers under Investment Advisers Act of 1940, Amendments to Custody Rule and Other Regulatory Developments Affecting Registered Investment Advisers ("RIAs")

Following a fifteen-month fact-finding examination of the operations and practices of hedge funds, on September 29, 2003, the staff of the Securities and Exchange Commission (the "SEC" or the "Commission") issued a detailed report on its findings and recommendations (the "Report"). The staff's key recommendation is that, subject to certain exceptions dealt with only in general terms in the Report, the Commission should exercise its authority to require hedge fund managers to register as investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act").

The Report points out that registration under the Advisers Act would subject hedge fund managers – and, to some extent, the hedge funds they manage – to a regulatory scheme that would permit the Commission and the staff to address concerns about the hedge fund industry cited in the Report. These concerns include: (i) lack of regulatory oversight needed both to detect and deter fraud by hedge fund managers and to gather information about an industry that has grown rapidly in size and significance to the U.S. financial system, (ii) lack of independent checks to assure proper valuation of hedge fund portfolio investments, (iii) increased risk that hedge funds may become "retailized"; i.e., marketed and sold to less sophisticated investors, (iv) lack of minimum disclosure requirements needed to ensure that hedge fund investors are properly informed and (v) conflicts of interest of hedge fund managers, both with investors in the hedge funds they manage and with other investment advisory clients.

While hedge fund managers are generally investment advisers as defined in the Advisers Act, most are not registered in reliance on Section 203(b)(3), which exempts from registration any investment adviser with fewer than 15 clients, provided the adviser does not hold himself out publicly as an investment adviser and does not act as an investment adviser to any investment company registered under the Investment Company Act of 1940 (the "Investment Company Act"). In determining the number of clients advised, hedge fund managers currently have the benefit of Rule 203(b)(3)-1, which treats each hedge fund as a single client, regardless of the number of investors, so long as the manager does not provide the investors with individualized advice about their investments in the fund. The Report states that the Commission could make the registration requirements of the Advisers Act applicable to most hedge fund managers merely by amending Rule 203(b)(3)-1 to treat each investor in a hedge fund as a separate client (in addition to the fund) for purpose of the fewer-than-15-clients exemption in Section 203(b)(3).

This suggestion is coupled with a recommendation that there be built into amended Rule 203(b)(3)-1 a registration threshold based on the aggregate amount managed by the hedge fund manager. While the Report does not specify a threshold amount, a footnote states that the amended rule should maintain an exemption for very small hedge funds whose investors are likely to have a personal relationship with the manager, and should be consistent with the $25,000,000 of assets under management minimum required for SEC registration under the Advisers Act. The Report also recommends that the amended rule apply only to hedge fund managers and not to managers of other types of private investment vehicles, such as venture capital funds, private equity funds, commodity pools and structured financing entities. Since the Report does not contain definitions to distinguish hedge funds from other private investment vehicles, however, determining whether the amended rule applies to the manager of an investment entity that combines features commonly associated with hedge funds and with one or more other private investment vehicles could be problematic.

If the Commission adopts the staff's recommendations, most hedge fund managers would be required to register as investment advisers on Form ADV. Part I of Form ADV, which contains general disclosures about the RIA's business and certain disciplinary information about the RIA and its advisory affiliates, must be filed electronically and updated at annual or more frequent intervals. Part II of Form ADV prescribes information about certain other matters, including the RIA's advisory services and fees, clientele, investment management techniques, brokerage allocations and conflicts of interest, that must be disclosed to clients and prospective clients by delivery of Part II or a brochure containing the prescribed information. In this connection, the Report recommends that the Advisers Act rule relating to Part II client disclosures be amended to require hedge fund managers to deliver a brochure specially designed for investors in the hedge funds they manage. In the staff's view, the disclosures contained in a specially-tailored brochure, coupled with further development and implementation of "best practices" in areas such as portfolio valuation, risk management performance presentation and conflicts of interest, should satisfactorily address many of the concerns discussed in the Report.

The Report also points out that mandatory registration of hedge fund managers would address the staff's concern about retailization of the hedge fund industry by effectively raising the standards for direct investment in hedge funds. While a small number of hedge funds accept investments only from investors who meet the stringent Investment Company Act test applicable to a "qualified purchaser" – generally, the holding of at least $5,000,000 in investments – most hedge funds currently apply the far less stringent wealth standard applicable to an "accreditor investor," as defined in Regulation D under the Securities Act of 1933 (the "Securities Act"). The accredited investor wealth standards, which have not been raised since Regulation D was adopted in 1982, can be met by any individual who with his or her spouse has a joint net worth of $1,000,000 or joint income above $300,000 for the preceding two years. While an offering of hedge fund interests limited to accredited investors would provide a basis for exemption of the offering from the Securities Act's registration requirements, the Regulation D wealth standards would not provide a registered hedge fund manager with an exemption from the compensation prohibitions of Section 205(a)(1) of the Advisers Act. Under that Section, the manager would be prohibited from receiving the form of incentive compensation almost universally paid in the hedge fund industry – an allocation or fee of 20% of net accumulated capital appreciation – unless each investor whose account is to be charged with the allocation or fee is a "qualified client," as defined in Rule 205-3(d) under the Advisers Act. Under this definition, the client must (i) have at least $750,000 under management by the RIA, or (ii) have (with his or her spouse if an individual) a net worth of more than $1,500,000 or (iii) be a "qualified purchaser" as defined in the Investment Company Act.

Apart from satisfying the filing and disclosure requirements of Form ADV and dealing with the compensation problems described above, a registered hedge fund manager would have to comply with all of the requirements and restrictions imposed on RIAs by the Advisers Act. These include Rule 206(4)-2, which makes it a violation of the antifraud provisions of Section 206(4) of the Advisers Act for a RIA to have custody or possession of any funds or securities of a client unless all of the conditions prescribed by the rule are met (the "Custody Rule"). The Commission recently adopted an amendment to the Custody Rule which contains special provisions applicable to RIAs who manage pooled investment vehicles, including hedge funds. Under the amended Custody Rule, which is to become effective on November 5, 2003 and must be complied with by RIAs by April 1, 2004, the term "custody" is defined in a manner making it clear that a RIA which acts both as general partner or managing member of, and investment adviser to, a pooled investment vehicle will be deemed to have custody of client assets; i.e., the assets of the pooled investment vehicle.

The amended Custody Rule requires, among other things, that RIAs having custody of client funds and securities must maintain them with qualified custodians – generally, banks, savings associations, broker-dealers registered under the Securities Exchange Act of 1934 and futures commission merchants registered under the Commodities Exchange Act. The RIA must also have a reasonable belief that the qualified custodian is providing account statements directly to clients or to a client's designated "independent representative" (which excludes the RIA and its affiliates) no less often than quarterly. If the account statements are instead provided to the RIA or an affiliate of the RIA, then the RIA must send the client the quarterly account statements and must undergo an annual surprise audit by an independent public accountant to verify the client's funds and securities. However, a RIA is exempt from these reporting and surprise audit requirements with respect to a client which is a pooled investment vehicle if the pooled investment vehicle (i) is audited at least annually and (ii) distributes its audited financial statement prepared in accordance with generally accepted accounting principles to all beneficial owners of interests in the vehicle within 120 days after the end of each fiscal year.

It is important for hedge fund managers who may be required to register under the Advisers Act to bear in mind that the regulatory complexities and compliance and expense burdens of RIA status are likely to increase over time. Under Proposed Rule 206(4)-7, which is still under consideration by the Commission, every RIA would be required: (i) to "adopt and implement written policies and procedures reasonably designed to prevent violations" of the Advisers Act and the rules thereunder by the RIA and its supervised persons, (ii) to "review no less frequently than annually the adequacy of the policies and procedures established and the effectiveness of their implementation" and (iii) to designate a chief compliance officer "who is responsible for administering the policies and procedures." The Commission Release announcing this proposed rule stressed the substantial burden that policing RIA compliance imposes on the staff – a burden that would increase significantly if most hedge fund managers were required to become RIAs – and proposed three possible ways to increase private sector involvement in the compliance process. These are: (1) periodic private review of each RIA by an independent compliance consultant, (2) a self-regulatory organization for the investment advisory/investment management industry and (3) fidelity bonding of (or, in the alternative, capital requirements for) RIAs who have custody of client assets.

We will keep you informed about further developments in these areas as they occur. In the meantime, if you would like further information about any of the matters discussed above, please let us know.

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