

**MEMO# 17829**

July 28, 2004

## **SEC PROPOSES REQUIRING HEDGE FUND ADVISERS TO REGISTER UNDER THE INVESTMENT ADVISERS ACT**

[17829] July 28, 2004 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 31-04 INTERNATIONAL COMMITTEE No. 41-04 INVESTMENT ADVISERS COMMITTEE No. 11-04 SEC RULES COMMITTEE No. 65-04 RE: SEC PROPOSES REQUIRING HEDGE FUND ADVISERS TO REGISTER UNDER THE INVESTMENT ADVISERS ACT In a three to two vote, the Securities and Exchange Commission has published for comment a new rule and rule amendments under the Investment Advisers Act of 1940 that would require advisers to certain private investment pools ("hedge funds") to register with the SEC under the Advisers Act.<sup>1</sup> These advisers would be subject to the entirety of the Advisers Act and the rules thereunder with certain limited exceptions as noted below. SEC Commissioners Cynthia A. Glassman and Paul S. Atkins dissented from the majority's proposal.<sup>2</sup> The most significant aspects of the proposal and dissent are summarized below. Comments on the proposal must be filed with the SEC no later than September 15, 2004. The Institute will hold a conference call on Wednesday, August 4th at 4:00 p.m. EST to discuss the proposal. The dial-in number for the call is 888-793-1858 and the pass code is Hedge Fund. If you plan to participate in the call, please send an e-mail to Stephanie Gerace at sgerace@ici.org. If you are unable to participate in the call, please provide your comments on the proposal, before the call, to the undersigned by phone (202-371-5410), fax (202-326- 5827), or e-mail (jheinrichs@ici.org).

I. Background The Release identifies several areas of concern regarding hedge funds, including the growth of hedge funds, the growth of hedge fund fraud, and the "retailization" of hedge funds. According to the Release, registration of hedge fund advisers would address these concerns and permit the SEC to do the following:

1 See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Advisers Act Release No. 2266 (July 20, 2004), 69 FR 45172 (July 28, 2004) ("Release"). The Release can be found on the SEC's website at <http://www.sec.gov/rules/proposed/ia-2266.htm>. 2 The dissent can be found on the SEC's website at <http://www.sec.gov/rules/proposed/ia-2266.htm#dissent>.

2 • Collect and provide to the public basic information about hedge funds and hedge fund advisers; • Examine hedge fund advisers to identify compliance problems early, identify practices that may be harmful to investors, and deter unlawful conduct; • Screen individuals associated with an adviser and deny registration if they have been convicted of a felony or had a disciplinary record subjecting them to statutory disqualification; • Require all hedge fund advisers to adopt basic compliance controls to prevent violation of the Advisers Act and to designate a chief compliance officer; and • Require all direct investors in hedge funds that charge performance fees to meet minimum standards of Rule 205-3 under the Advisers Act.<sup>3</sup>

II. Proposed Rule 203(b)(3)-2 Proposed Rule 203(b)(3)-2 under the Advisers Act would require

advisers to “private funds” to register with the SEC by requiring the advisers to “look through” the funds (including registered investment companies) and to count the number of investors (rather than the fund) when determining whether the advisers are eligible for the Advisers Act’s exemption for advisers with 14 or fewer clients.<sup>4</sup> A “private fund” would be one that • 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; • permits owners to redeem their ownership interests within two years of purchase; and • is offered based on the investment advisory skills, ability or expertise of the investment adviser. <sup>3</sup> Rule 205-3 permits registered investment advisers to charge performance fees only to “qualified clients” that, for instance, have a net worth of at least \$1.5 million or have at least \$750,000 of assets under management with the adviser. <sup>4</sup> Many hedge fund advisers currently are not required to register under the Advisers Act in reliance on the “private adviser” exemption in Section 203(b)(3) (i.e., advisers that have had 14 or fewer clients during the preceding twelve months and that do not hold themselves out generally to the public as investment advisers). <sup>5</sup> Section 3(c)(1) of the Investment Company Act excludes from the definition of “investment company” those funds with fewer than 100 shareholders and Section 3(c)(7) of the Investment Company Act excludes from the definition of investment company those funds that permit only investors that are “qualified purchasers,” which for natural persons generally means having investments of at least \$5 million. <sup>3</sup> Rule 203(b)(3)-2 also would contain special provisions for advisers located outside the United States designed to limit the extraterritorial application of the Advisers Act to offshore advisers to offshore funds that have U.S. investors.

III. Rule Amendments In addition to proposed Rule 203(b)(3)-2, the SEC has proposed a number of amendments to rules under the Advisers Act, including the following: • amendments to Rule 204-2, the adviser recordkeeping rule, that would require new registrants required to register under new Rule 203(b)(3)-2 that make claims concerning their performance “track record” to retain whatever records they do have that support the performance they earned prior to their registration with the SEC, but would excuse them from the SEC’s recordkeeping rule to the extent that those records are incomplete or otherwise do not meet the requirements of Rule 204-2; • amendments to Rule 204-2 that clarify that, for purposes of Section 204 of the Advisers Act, the books and records of a hedge fund adviser registered with the SEC include records of the private funds for which the adviser acts as general partner; • amendments to Rule 205-3 that would allow a hedge fund’s current investors who are not qualified clients (i.e., do not have either a net worth of at least \$1.5 million or at least \$750,000 of assets under management with the adviser) to retain their existing investment in that fund, and to add to their accounts; and • amendments to Rule 206(4)-2, the adviser custody rule, to accommodate advisers to funds of hedge funds.<sup>7</sup> Under the proposal, advisers to pooled investment vehicles, including hedge funds, would be able to satisfy their obligation to deliver custody account information to investors by distributing the pool’s audited financial statements to investors within 180 days of the pool’s fiscal year end (rather than 120 days as is currently required for pooled investment vehicles). The SEC has also proposed to amend Form ADV to identify advisers to hedge funds. The current Form ADV collects information about advisers to pooled investment vehicles without distinguishing hedge fund advisers from other advisers.

<sup>6</sup> The Release notes that once a hedge fund is registered with the SEC, it must comply with the SEC’s recordkeeping rule going forward. Under the SEC’s current recordkeeping rule, a registered investment adviser that makes claims concerning its performance must keep documentation supporting those performance claims. The supporting records must be retained for a period of five years after the performance is last used. <sup>7</sup> Rule 206(4)-2 makes clear that an adviser acting as general partner to a pooled investment vehicle it manages has custody of the pool’s assets. <sup>4</sup>

IV. Request for Comment In addition to seeking comment on the SEC’s proposed rule and rule amendments generally, the Release seeks

comment specifically on a number of issues, including the following:

- Whether any of the rules or forms under the Advisers Act should be tailored for hedge fund advisers;
- The new rule would not alter the minimum assets under management that an investment adviser must have in order to be eligible to register with the SEC.<sup>8</sup> The Release requests comment, however, on whether the minimum asset thresholds applicable to hedge fund advisers should be higher or lower; and
- Whether the definition of “private fund” should include private equity, venture capital and other investment pools that are not hedge funds.

V. Dissent In a joint dissent to the Release, Commissioners Glassman and Atkins state that their primary purpose in writing the dissent is to encourage commenters to respond to the issues discussed in the Release and to address the numerous issues that the Release does not raise. The dissent notes that “[t]he majority proposes a solution to an ill-defined problem without having given proper consideration to viable solutions in light of the limitations of our own capabilities.” While acknowledging that the SEC does not know everything it would like to know about hedge funds and hedge fund advisers, the dissent states that mandatory registration of hedge fund advisers would not fill in these “information gaps” and instead would “significantly” increase industry and SEC burdens. In support of their dissent, Commissioners Glassman and Atkins note, among other things, the following: Form ADV, without “considerable further amendment” will not provide sufficient details about hedge fund advisers; there is no evidence of significant retailization; and the SEC should explore alternative approaches. The dissent concludes by urging commenters to address the issues in the Release as well as other issues, including the following:

- Whether approaches other than hedge fund registration would be effective in addressing the concerns raised by the majority, e.g., should the SEC adjust the eligibility criteria for hedge fund investors or would a notice filing and reporting regime be a better alternative to Advisers Act registration, and
- 8 Hedge fund advisers with assets under management of less than \$25 million would continue generally not to be eligible for SEC registration (unless they also advise a registered investment company or qualify for registration under one of the SEC’s exemptive rules) and hedge fund advisers with assets under management between \$25 and \$30 million would be eligible, but not required, to register with the SEC.

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- Whether the information provided on Form ADV would be sufficient to address the majority’s concerns about hedge funds.

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