August 5, 2004

SECURITIES

SEC Proposes to Require Hedge Fund Adviser Registration

On July 12, 2004, in a rare, divided (3-2) vote, the Securities and Exchange Commission proposed the adoption of a new rule that would require hedge fund advisers to register with the SEC under the Investment Advisers Act of 1940. The SEC also proposed various related rule and form amendments under the Advisers Act.

On July 20, 2004, the text of the proposed release was made publicly available, with the views of the two dissenting Commissioners attached as an Appendix.[1] The deadline for submitting comments on the proposal is September 15, 2004, and the SEC is expected to take final action by the end of the year. Please note that the rules described in this memo are proposed rules and have not been adopted by the SEC, and that final rules, if adopted, may differ significantly from those described below.

BACKGROUND

Currently under the Advisers Act and the rules thereunder, advisers to hedge funds are not required to register with the SEC under the so-called "private adviser exemption." Section 203(b)(3) of the Advisers Act provides that an investment adviser is not required to register with the SEC if it (i) has had fewer than 15 clients during the preceding 12 months, (ii) does not hold itself out generally to the public as an investment adviser, and (iii) is not an adviser to a registered investment company.

In 1985, in response to uncertainty as to whether an adviser that served as general partner to a limited partnership holding investment securities was required to count each limited partner as a client, the SEC adopted Rule 203(b)(3)-1, which permits an adviser to treat a limited partnership as one "client" for purposes of the private adviser exemption, if the advice provided to the limited partnership is based on the investment objectives of the partnership rather than those of the various limited partners. In 1997 the SEC expanded this rule to cover other types of legal entities that advisers use to pool client assets.

In the last ten years, the hedge fund industry has grown dramatically. It is estimated that there are 7,000 active hedge funds today, up five times from ten years ago, and at least $795 billion in assets under management in hedge funds, up fifteen-fold during the same period. In addition, in recent years, the universe of hedge fund investors has expanded beyond high net worth individuals to include smaller investors and pensioners (through their pension plans). The introduction of new products such as the registered "fund of hedge funds," which is offered publicly and typically has reduced minimum investment requirements from those imposed by the underlying hedge funds themselves, has made this class of investment more broadly available to investors. This rapid growth in the size and scope of hedge funds is expected to continue.[2]

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[1] Release No. 1A-2266<http://www.sec.gov/rules/proposed/ia-2266.htm>.

[2] See the proposing release, at pp. 11-12, 16-20.

SECURITIES

Recent Developments

In the last few years, the SEC and others have shown increasing concern about the risk of hedge funds to investors and the markets in general.

- In 1999 the President's Working Group on Financial Markets, which includes representatives from the SEC, the Treasury Department, the Federal Reserve and the Commodity Futures Trading Commission, issued a report on the near collapse of Long-Term Capital Management, which focused on the exposure of banks and others to the risks of highly leveraged entities such as hedge funds.

- In May 2003, the SEC held a Hedge Fund Roundtable and invited a broad spectrum from the hedge fund industry to participate in order to expand its understanding of the size and impact of the operations of hedge funds.

- In September 2003, the SEC staff published a report entitled "Implications of the Growth of Hedge Funds."[3] The Report focused on investor protection concerns as a result of the growth of hedge funds and recommended that the SEC improve the current system of hedge fund regulation and oversight. The staff's principal recommendation was that hedge fund advisers be required to register as investment advisers under the Advisers Act.

- Shortly after the SEC's Report was released, investigations revealed that hedge fund advisers, such as Canary Investment Management, LLC, had played a significant role in the mutual fund late trading and market timing scandals, thereby increasing the SEC's conviction that it needs more information about hedge funds and their trading activities.

Current Requirements for Registered Investment Advisers

Once registered, an investment adviser becomes subject to various ongoing requirements, and compliance with these requirements is enforced by periodic SEC examinations.

Certain Requirements under the Advisers Act

- Filing Form ADV and annual updates describing, among other things, the business practices, ownership and disciplinary history of the adviser (Advisers Act Rules 203-1 and 204-1)

- Providing the investment brochure (prepared but not filed with the Form ADV) to the adviser's clients (Advisers Act Rule 204-3)

- Restrictions on fees that the adviser may charge clients, as well as on fees that can be paid to third party solicitors of clients (Advisers Act Section 205 and Rules 205-3 and 206(4)-3)

- Ongoing recordkeeping requirements (Advisers Act Rule 204-2)

- Providing clients with audited annual financial statements if the adviser has custody of client assets (Advisers Act Rule 206(4)-2)

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[3] Available at <http://www.sec.gov/spotlight/hedgefunds.htm>.

- Informing clients of the adviser's proxy voting practices (Advisers Act Rule 206(4)-6)

- Adopting a compliance system to govern the adviser's operations, including requirements to (i) adopt and implement policies and procedures designed to prevent violations of the securities laws, (ii) review these policies and procedures at least annually for their adequacy and the effectiveness of their implementation, and (iii) designate a chief compliance officer responsible for administering the policies and procedures (Advisers Act Rule 206(4)-7)

BENEFITS OF HEDGE FUND ADVISER REGISTRATION

The SEC estimates that approximately 40-50% of all hedge fund advisers are currently registered with the SEC. In many cases, hedge fund advisers have registered on a voluntary basis in order to attract investment from specific clients, such as pension plans, that require or prefer registration. The SEC believes that requiring registration by hedge fund advisers has important benefits not only for hedge fund investors but also for mutual fund and other investors, the financial markets, regulatory policy and other hedge fund advisers, while imposing minimal burdens on the registering advisers.

Benefits of Hedge Fund Adviser Registration

- Deterrence and early detection of fraud by allowing the SEC to conduct regular examinations of hedge fund advisers

- Collection of basic information about hedge fund advisers through the filing of the Form ADV (as described above)

- Improvement of compliance controls by requiring hedge fund advisers to have comprehensive compliance procedures and to designate a chief compliance officer

WHO IS COVERED?

Under the proposed rules, an adviser to a hedge fund (whether the general partner of a limited partnership, the managing member of a limited liability company or any other person acting as an investment adviser to a limited partnership, limited liability company or other legal entity) would be required to register with the SEC as an investment adviser if it is (1) a hedge fund with (2) 15 or more investors and (3) $25 million or more in assets under management.

Surprisingly, the term "hedge fund" does not appear in the proposed rules. Rather the SEC has added a new definition of the term "client" for purposes of the provision that exempts an adviser from registration if it has fewer than 15 clients. The new definition provides that if the client is a "private fund" (as defined below), the adviser must look through the fund and count each owner of the fund as a client.

SECURITIES

1. What is a hedge fund?

For purposes of determining which pooled investment vehicles constitute hedge funds, the SEC has added a definition of a "private fund,"[4] i.e., a company

- that would be an investment company required to register under the Investment Company Act of 1940 but for the exceptions under Section 3(c)(1) exempting issuers with fewer than 100 investors or Section 3(c)(7) exempting issuers whose owners are all "qualified purchasers;"[5]

- that permits its owners to redeem any portion of their ownership interests within two years of purchase (see description of "lockup" below);[6] and

- the interests in which are offered based on the investment advisory skills, ability or expertise of the investment adviser.

Funds with a "lockup" of two years or more are excluded from the definition of "private fund" and, therefore, not covered by the proposed registration requirements, subject to the following:

- the "lockup" period must apply to both a client's initial investment as well as each additional investment;

- the lockup may permit redemption in less than two years in the event of "extraordinary and unforeseeable" circumstances, such as tax or regulatory reasons, or the investor's death or disability; and

- the "lockup" may permit redemption in less than two years of interests acquired with reinvested dividends.

2. Does the adviser have 15 or more clients?

Under proposed Rule 203(b)(3)-2, an adviser to one or more "private funds" would be required to "look through" each of the funds described under (1) above and count as "clients" the total number of investors (including U.S. and foreign investors) in all of these funds to determine whether the adviser meets the 15-client threshold.

If any of the investors in a "private fund" is a registered investment company under the Investment Company Act, the adviser would have to "look through" the registered fund and count its investors for purposes of the 15-client threshold. This provision is intended to prevent a hedge fund adviser from providing its services to a large number of investors through 14 or fewer "funds of funds."

Note on Special Rules for Offshore Advisers: Under proposed Rule 203(b)(3)-1(b)(5), for purposes of the 15-client threshold, offshore advisers to "private funds" would be required to count as clients only those investors that are U.S. residents. This would be true whether the fund is located offshore or in the U.S. However, if an

[4] This definition is very similar to the definition of "unregistered investment company" contained in the Department of Treasury's proposed rule requiring certain unregistered investment companies to adopt anti-money laundering programs. See Financial Crimes Enforcement Network: Anti-Money Laundering Programs for Unregistered Investment Companies, Department of Treasury Release, 67 Fed. Reg. 60618 (Sep. 26, 2002).

[5] The Investment Company Act of 1940 defines "qualified purchaser" to include, among others, any individual that owns not less than $5 million in investments, and any person acting on its own account or the account of others that owns and invests on a discretionary basis not less than $25 million in investments.

[6] Since most private equity and venture capital funds do not offer their investors any redemption rights, other than in certain limited extraordinary circumstances, they will not be covered by the definition of "private fund."

offshore adviser to an offshore fund is required to register due to the existence of U.S. investors in the fund, the SEC has proposed that such adviser would only be subject to the anti-fraud provisions of the Advisers Act and not the various rules relating to books and records, custody and compliance. (Proposed Rule 203(b)(3)-2(c))[7]

3. Does the adviser have $25 million or more in assets under management?

The new rule would not change the current requirement under the Advisers Act that in order to be eligible to register with the SEC, an investment adviser must have aggregate assets under management of $25 million or more.[8] Regulation, including registration, of investment advisers with less than $25 million in assets under management would remain with the applicable state securities authorities.

Proposed Amendments to the Advisers Act

Once registered, hedge fund advisers would be subject to the ongoing requirements of the Advisers Act. The SEC has proposed a number of amendments to these requirements to facilitate a smooth transition for hedge fund advisers.

1. Transition Amendments

	Current Rule	**Proposed Rule**
Performance Fees Advisers Act Rule 205-3	Registered advisers may only charge performance fees – i.e. fees based on a client's realized capital gains and unrealized capital appreciation – if the client meets the requirements of a "qualified client" (see below).	Includes a "grandfather" provision, under which a newly registered adviser to a hedge fund would be permitted to continue to charge a performance fee (or incentive allocation) on capital of investors in the fund that are not "qualified clients" if they invested in the fund before the effective date of the new rules.
Recordkeeping Advisers Act Rule 204-2	Registered advisers are required to retain records of, among other things, their performance or rate of return claims used to solicit new and existing investors for a period of five years after the performance information is last used.	Newly registered advisers would be permitted to use performance information relating to periods prior to the effective date of the new rules without maintaining records supporting such information. This amendment is intended to avoid putting newly registered advisers at a competitive disadvantage in promoting their returns. There is also a proposed rule to clarify that the books and records of registered advisers include the records of the "private funds" for which the adviser acts as general partner, managing member or in a similar capacity.

[7] Offshore advisers to offshore funds that are publicly offered and regulated as public investment companies under the laws of a country other than the U.S. would not be required to register simply because more than 14 of the investors in any such offshore fund are U.S. residents. Under proposed Rule 203(b)(3)-2(d)(3), such offshore mutual funds would be excluded from the definition of "private fund."

[8] There are several exceptions to the $25 million threshold requirement, including, among others, for (i) investment advisers that manage a registered investment company, (ii) investment advisers that would otherwise be required by the laws of 30 or more states to register as an investment adviser in each such state, and (iii) newly formed advisers that expect to be eligible for registration (i.e. to be managing $25 million or more in capital) within 120 days of registration.

	Current Rule	Proposed Rule
Custody Advisers Act Rule 206(4)-2	Registered advisers with custody of client assets (which most advisers to hedge funds are deemed to have) are required to deliver audited financial statements to clients within 120 days of the fund's fiscal year end.	The SEC has proposed to extend this period from 120 days to 180 days after fiscal year end, so that, in particular, advisers to funds of hedge funds will have time to collect the information they need from the underlying funds in order to prepare such audited financial statements.

A qualified client includes

- a person who has a net worth of more than $1.5 million,
- a person with at least $750,000 of assets under management with the investment adviser immediately after the advisory agreement is entered into,
- an executive officer, director, trustee, general partner or person serving in a similar capacity of the investment adviser, or
- an employee of the investment adviser who participates in the investment activities of such investment adviser and has been performing such functions on behalf of the investment adviser or substantially similar functions or duties for or on behalf of another company for the last 12 months.

2. Form ADV

Form ADV, the investment adviser registration form, requires basic information regarding the adviser's experience, ownership and affiliates, disciplinary history as well as certain aspects of its business and possible conflicts of interest. Form ADV does not require much substantive disclosure of the adviser's investment activities in recognition of the adviser's need to keep proprietary investment strategies confidential.

The SEC is proposing to amend Form ADV to require advisers to "private funds" to identify themselves as hedge fund advisers, to identify each hedge fund they manage and to provide specific information as to each such fund, including, among other things, the minimum investment requirements and the current value of the fund's assets.

State Investment Adviser Requirements

State investment adviser registration and other requirements are not affected by the SEC's proposals.[9] It is possible, however, that state authorities may seek to adopt rules similar to the proposed federal rules. In such event, those hedge fund advisers that are not eligible to register with the SEC because their assets under management fall below the SEC's $25 million threshold, would be required to register in certain states.

[9] Currently, advisers registered with the SEC under the Advisers Act are not required to register with the state securities authorities and are exempt from most substantive provisions of state investment adviser laws.

SECURITIES

CONCLUSION

As suggested above and in the SEC's proposing release, the expected benefits of hedge fund adviser registration should include providing the SEC with information to detect and prevent fraud, providing investors with fundamental information about their hedge fund advisers and requiring hedge fund advisers to adhere to compliance procedures. The proposed rules have been hotly debated, however, even before they were announced, evidencing far from universal concurrence in their merit. In addition to numerous executives from the hedge fund industry, those weighing in against the proposals include government officials, such as Federal Reserve Board Chairman Alan Greenspan and CFTC General Counsel Patrick McCarty, the media[10] and two of the five SEC Commissioners, namely Paul Atkins and Cynthia Glassman.

Detractors point to a number of weaknesses, including the following: (i) the information provided on Form ADV is non-substantive and insufficient to assist the SEC in curbing fraud, suggesting a likely false reliance on the rules from an investor protection standpoint, (ii) the risks posed by hedge funds do not justify the reallocation of SEC resources away from other, higher priorities like regulating mutual funds and public companies, and (iii) the new rules will likely lead to more substantive regulation of hedge funds which will impair their ability to operate, and in particular, to provide much needed liquidity to the financial markets. The arguments on both sides of this debate have their strengths. The SEC will want to study carefully the inevitable wake of commentary it will receive. Fitting, perhaps, for this season, this one may be too close to call.

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[10] See "Hands Off Hedge Funds," *The Washington Post* (Jul. 17, 2004); "Too stern a hand," *The Economist* (Jul. 17, 2004).