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a note from Tannenbaum Helpern Syracuse & Hirschtritt LLP SEC Chairman Donaldson Confirms Preparation of Proposed Rule to Require Hedge Fund Managers to Register as Investment Advisers¹

**To: Clients and Friends of Tannenbaum Helpern Syracuse
Hirschtritt LLP**

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Chairman Donaldson's Remarks

On March 5, 2004, Securities and Exchange ("SEC") Chairman William H. Donaldson confirmed that the SEC staff is preparing a proposed rule that would require hedge fund managers to register as investment advisers with the SEC under the Investment Advisers Act of 1940, as amended (the "Advisers Act").²

Chairman Donaldson's reiterated the SEC staff's findings and concerns that were released in a report entitled "Implications of the Growth of Hedge Funds"³ with respect to the SEC's limited ability to obtain comprehensive and reliable information about hedge funds.⁴ As such, the proposal to require investment adviser registration is to enable the SEC to collect reliable information on hedge funds which Chairman Donaldson noted is a financial sector growing rapidly towards \$1 trillion. Furthermore, in reference to the Hedge Fund Report, Chairman Donaldson stated that registration would give the SEC greater insight into the activities of hedge fund managers and improve the SEC's ability to detect and deter fraud.⁵

On the following day, Deputy Director Cynthia M. Fornelli repeated Chairman Donaldson's statements that the proposal to require registration is designed for the SEC to improve its understanding and oversight of hedge fund operations.⁶ Furthermore, Deputy Director Fornelli emphasized that investment adviser registration would not require hedge fund managers to

¹ This memorandum provides general information on the subject matter described, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects treated here.

² Speech by SEC Staff: Remarks to the Practising Law Institute, by William H. Donaldson, Chairman U.S. Securities and Exchange Commission, Washington, D.C. (March 5, 2004).

³ "Implications of the Growth of Hedge Funds," Staff Report to the SEC (September 2003) (the "Hedge Fund Report").

⁴ See Part VI.A.2 of the Hedge Fund Report.

⁵ In the Hedge Fund Report, the SEC staff expressed its belief that investment adviser registration would allow the SEC to collect basic information about hedge fund advisers. Moreover, according to the SEC staff, registration would enable the SEC to more comprehensively and effectively observe the trading activities of hedge funds which in turn would make it easier for the SEC to detect improper or illegal trading practices. See Part VII.A.1.c. of the Hedge Fund Report. Furthermore, the SEC staff stated that the prospect of SEC examinations would serve as a deterrent to fraud and other misconduct. See Part VII.A.1.a. of the Hedge Fund Report.

⁶ Remarks to the Practising Law Institute, by Cynthia M. Fornelli, Deputy Director of the Division of Investment Management of the SEC, Washington, D.C. (March 6, 2004).

disclose their investment strategies.⁷ Moreover, investment adviser registration would not result in the SEC imposing restrictions on a fund manager's trading techniques.⁸

What the Hedge Fund Industry Can Expect

Based on the SEC staff's discussion in the Hedge Fund Report, the hedge fund industry should expect changes to Rule 203(b)(3)-1 of the Advisers Act because this provision has enabled unregistered hedge fund managers to rely on the exemption from registration with the SEC pursuant to Section 203(b)(3) of the Act.⁹ Currently, under Rule 203(b)(3)-1(a)(2)(i) of the Act, a fund, e.g., a corporation, limited partnership, limited liability company or other legal organization, is considered to be a "client" and not the underlying beneficial owners of a fund. As such, unregistered hedge fund managers that manage over \$25 million of assets have not been required to register with the SEC because such managers have fourteen or less clients, i.e., they manage fourteen or less funds. In the Hedge Fund Report, the SEC staff recommended that the SEC amend Rule 203(b)(3)-1 of the Act and redefine the term client by requiring fund managers to "look through" any hedge funds that they manage and to count each separate investor in a fund as a client.¹⁰ If the proposed rules adopt the SEC staff's recommendations in the Hedge Fund Report, then it is likely that Rule 203(b)(3)-1 of the Act would be amended whereby each beneficial owner of a fund would be considered to be a client and not the fund itself.

Furthermore, it is possible that the SEC will impose a financial threshold to trigger registration with the SEC.¹¹ A likely condition for registration is for the SEC to require hedge fund managers to manage at least \$25 million of assets.¹² In the Hedge Fund Report, the SEC staff noted that in the changes to the Advisers Act adopted pursuant to the National Securities Markets Improvement Act of 1996 ("NSMIA"), registration as an investment adviser with the SEC was triggered at the \$25 million threshold.¹³ It is possible that the SEC will continue to use \$25 million of assets under management as the threshold to require investment adviser registration or perhaps adopt \$30 million as the threshold that since \$30 million is the amount that triggers mandatory registration. As such, the bifurcated regulatory scheme adopted pursuant to NSMIA whereby advisers with less than \$25 million are subject to state regulation and advisers with more

⁷ In the Hedge Fund Report, the SEC staff stated that registration would not require the disclosure of any proprietary trading strategy. See Part VII.A. of the Hedge Fund Report.

⁸ In the Hedge Fund Report, the SEC staff stated that registration would not result in regulating a fund manager's ability to effectuate its investment strategies. According to the staff, registration would not impose any restrictions on a fund manager's ability to trade securities, use leverage, sell securities short or enter into derivative transactions. See Part VII.A. of the Hedge Fund Report.

⁹ Under Section 203(b)(3) of the Advisers Act, an investment adviser that is otherwise required to register as an investment adviser with the SEC is exempt from registration if during the preceding 12 months the investment adviser has had fewer than 15 clients and neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Advisers Act or a business development company. See Section 203(b)(3) of the Advisers Act.

¹⁰ See Part VII.A. of the Hedge Fund Report.

¹¹ In the Hedge Fund Report, the SEC staff stated that the SEC should consider incorporating into any such amendment to the Advisers Act a threshold for SEC registration based upon the aggregate amount of assets managed by the hedge fund manager. See Part VII.A. of the Hedge Fund Report.

¹² See Part VII.A., note 293 of the Hedge Fund Report. Note that currently, it is permissible for an adviser that has between \$25 million and \$30 million of assets under management to register with the SEC *unless* an exemption applies. See Rule 204A-1(a)(2) of the Advisers Act. Furthermore, currently, it is mandatory for an adviser that has \$30 million or more of assets under management to register with the SEC *unless* an exemption applies. See Rule 204A-1(a)(1) of the Advisers Act.

¹³ See Part VII.A., note 293 of the Hedge Fund Report.

than \$25 million are subject to federal regulation will likely remain intact or be amended to raise the threshold for federal registration to \$30 million.¹⁴

If these assumptions materialize in the proposed rules, then accordingly, a hedge fund manager that that has fifteen or more investors in a fund and that has \$25 million (or perhaps \$30 million) or more assets under management would be required to register as an investment adviser with the SEC.

It remains to be seen whether the proposed rule will include the SEC staff's recommendation that hedge fund managers registered with the SEC file with the SEC and distribute to each beneficial owners in a fund a disclosure statement that is tailored for hedge funds investors (the "Hedge Fund Brochure").¹⁵ The impetus behind the Hedge Fund Brochure is the SEC staff's belief that the Hedge Fund Brochure would make the due diligence process more efficient and would provide investors with more current information about the operations of the hedge fund manager and the strategies, policies, management, and operations of the hedge fund(s) that the fund manager operates.¹⁶ According to the SEC staff, the Hedge Fund Brochure would provide disclosures regarding conflicts of interests, risk management techniques, the valuation methodology of the fund's portfolio, whether there is any independent verification of the portfolio's valuation, and what lock-up periods may apply.¹⁷ Whether such a Hedge Fund Brochure would supplement Part II of the Form ADV or would serve in lieu of Part II of the Form ADV remains to be seen. Another reason for the recommendation of the Hedge Fund Brochure is the SEC staff's perceived limitations of the Form ADV with respect to hedge fund managers.¹⁸ According to the SEC staff, the Form ADV is designed to provide investors information about the investment advisers themselves and not necessarily about the funds.¹⁹ In light of the SEC's campaign to increase transparency in hedge funds, even if the proposed rule does not include mandating a Hedge Fund Brochure, the hedge fund industry should expect a modified Form ADV for hedge fund managers designed to elicit more information about the funds that they operate.

Extra-Jurisdictional Impact?

An area of potential concern is whether non-U.S. fund managers that have U.S. clients will have to register as investment advisers with the SEC as well. Currently, under Rule 203(b)(3)-1(b)(5) of the Advisers Act, a non-U.S. investment adviser does not have to register with the SEC if it has fourteen or less U.S. clients.²⁰ In the context of funds, this means a non-U.S. fund manager can manage up to fourteen U.S.-domiciled funds without having to register with the SEC. However, if Rule 203(b)(3)-1 of the Act is amended whereby there is a look-through so that each beneficial owner in a fund is counted as a separate client, then there is the possibility that a non-U.S. fund manager that has fifteen or more U.S. investors would be required to register with the SEC. Such an outcome will likely be perceived by the international community to be an over-extension of

¹⁴ See Release No. 1633 (May 15, 1997).

¹⁵ See Part VII.B. of the Hedge Fund Report.

¹⁶ See Part VII.B. of the Hedge Fund Report.

¹⁷ The SEC staff believes that such disclosures should appear in a brochure regardless of whether the information appears in a hedge fund's private placement memorandum because such a brochure would have to be updated periodically and then provided to investors. See Part VII.B. of the Hedge Fund Report.

¹⁸ See Part VII.B. of the Hedge Fund Report.

¹⁹ See Part VII.B. of the Hedge Fund Report.

²⁰ "An investment adviser that has its principal office and place of business outside of the United States must count only clients that are United States residents; ..." See Rule 203A-1(b)(5) of the Advisers Act.

SEC jurisdiction. Moreover, this may create a chilling effect in the international financial markets whereby non-U.S. fund managers may close their doors to U.S. investment if accepting U.S. investors results in registration with the SEC.

An Opportunity to Respond to the Proposed Rules

Chairman Donaldson did not indicate the timetable as to when the proposed rules will be released. Chairman Donaldson did state that the SEC will solicit comments from all interested parties to ensure that the final rule strikes the right balance between the SEC having oversight over hedge funds and supporting the important role that hedge funds can play in the financial markets. Chairman Donaldson's closing remarks echo his closing statements at the SEC Hedge Fund Roundtable in May 2003 when he invited the hedge fund industry to submit papers and comments on hedge funds because the discussion on hedge funds did not end with the close of the Roundtable. The hedge fund industry should heed Chairman Donaldson's invitation and respond accordingly when the proposed rules are released. The hedge fund industry must continue the dialogue with regulators so that the final rules do indeed strike a balance between the SEC's regulatory concerns and the autonomy of the hedge fund industry to operate in today's capital markets.

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If you have any questions or comments regarding the Chairman Donaldson's comments, the Hedge Fund Report, or compliance with the Advisers Act, please feel free to contact:

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