



# bullet point

## SEC Commissioners Approve Proposed Rules to Require Certain Hedge Fund Managers to Register with the SEC<sup>1</sup>

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

**Date:** October 27, 2004

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On October 26, 2004, the Commissioners of the Securities and Exchange Commission (the “SEC”) approved the proposed rule<sup>2</sup> in a 3-2 vote to require certain hedge fund managers to register as investment advisers with the SEC.<sup>3</sup> The final rules are expected to become effective in February of 2006. Note that as of this writing, the actual SEC release setting forth the final rules has not been published so that the details are not yet available. As soon as they are published, we will update this memorandum.

### What Can the Hedge Fund Industry Expect

According to the SEC, the proposed rules will be adopted substantially as they were proposed with some modifications to account for industry commentary received by the SEC. As such, hedge fund managers that operate “private funds”<sup>4</sup> will be required to count each shareholder, limited partner, member, other securityholder or beneficiary of a private fund as a client.<sup>5</sup> If there are fifteen or more clients, the investment vehicle falls

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<sup>1</sup> 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.

<sup>2</sup> See Securities and Exchange Commission; Registration Under the Advisers Act of Certain Hedge Fund Advisers; proposed rule. 69 Fed. Reg. 45172 (July 28, 2004).

<sup>3</sup> Chairman William H. Donaldson, Commissioner Harvey J. Goldschmid, and Commissioner Roel C. Campos voted in favor of adopting the proposed rules. Commissioner Cynthia A. Glassman and Commissioner Paul S. Atkins voted against adopting the proposed rules.

<sup>4</sup> According to proposed Rule 203(b)(3)-2(d)(1), a “private fund” is defined to mean a company:

- (i) that would be an investment company under Section 3(a) of the Investment Company Act of 1940, as amended (the “Company Act”) but for the exception provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of such Act;
- (ii) that permits owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and
- (iii) interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.

See proposed Rule 203(b)(3)-2(d)(1)(i)-(iii); 69 Fed. Reg. at 45184-45185.

<sup>5</sup> See proposed Rule 203(b)(3)-2(a) of the Advisers Act.

within the definition of “private fund,” and the fund manager has U.S.\$25 million<sup>6</sup> or more assets under management, then the fund manager will be required to register with the SEC pursuant to the Investment Advisers Act of 1940, as amended (the “Advisers Act”).

The final rules will include transitional rules to ameliorate the impact of registration. For example, the SEC has adopted proposed Rule 205-3(c)(2) to permit current investors in a “private fund” that are not qualified clients (as such term is defined in Rule 205-3 of the Advisers Act) to be grandfathered into the “private fund” so that the investors may remain in the fund and that the fund manager may continue to charge them a performance fee.<sup>7</sup>

Also, the SEC is adopting the proposal that will permit hedge fund managers that are required to register with the SEC to use past performance information relating to the period prior to their registration without being subject to the requirements that such advisers maintain records supporting the performance information.<sup>8</sup>

Furthermore, the two-year lock up period that is contained in the definition of “private fund” will not be applied retroactively but rather will apply to “private funds” that launch after February 2006 so as not to disrupt current arrangements of existing hedge funds.

The final rules should neither interfere nor restrict hedge fund managers with respect to their investment strategy. Commissioners Goldschmid and Campos emphasized that the final rules requiring registration under the Advisers Act are not intended to alter or impede the operations, flexibility or creativity of hedge fund managers.

Hedge fund managers registered with the SEC should expect to be subject to a risk-based inspection program. According to Commissioner Campos, as a means to address the concerns that the SEC staff lacks the resources and expertise to examine hedge fund managers, a task force headed by Charles Fishkin, the Director of the Office of Risk Assessment of the SEC, has been created to develop a process for a risk-based inspection regime that is to be ready by February 2006.

Finally, the hedge fund industry should expect the rules that go into effect in February 2006 to be modified and refined compared to the final rules that will be released this year in light of Commissioner Campos’ comment that the hedge fund industry can still comment on the final rules and that the SEC staff will continue to seek input from hedge fund managers currently registered and those that will be required to register to improve the final rules so that they are workable.

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<sup>6</sup> Note that under current law, it is permissible for an investment adviser to register with the SEC if it manages \$25 million or more of assets under management. It is mandatory for an investment adviser to register with the SEC if manages \$30 million or more of assets under management absent an exemption from registration, e.g. Section 203(b)(3) of the Advisers Act. See Section 203(b)(3) of the Advisers Act.

<sup>7</sup> See 69 Fed. Reg. at 45186, note 156.

<sup>8</sup> See proposed Rule 204-2(e)(3)(ii) of the Advisers Act; 69 Fed. Reg. at 45185-45186.

## **Issues Leading to Registration and the Benefits of Registration**

### A. Issues Leading to Registration

According to Paul F. Roye, Director of the Division of Investment Management of the SEC, the issues that led to the recommendation that certain hedge fund managers register with the Commission are:

The tremendous growth of the hedge fund industry – the hedge fund industry has grown by 260% in recent years and assets are approximately \$870 billion. The SEC expects the hedge fund industry to have over \$1 trillion of assets under management by the end of 2004.

Lack of information about hedge funds - the SEC staff and other governmental agencies lack reliable data about the hedge fund industry. The SEC staff finds current sources (third party surveys and reports) to be inadequate.

Retailization – hedge funds are no longer the province of the “very rich” because pensioners, charities, and foundations are investing increasing amounts of assets in hedge funds resulting in increased exposure to risk by non-traditional hedge fund investors who cannot absorb the losses associated with investing in a hedge fund.

Increased instances of hedge fund fraud – the growth in the number of hedge funds appears to coincide with the increased number of SEC enforcement cases against hedge funds.

Market timing and late trading – the SEC staff considers hedge fund managers as the key participants in the market timing and late trading scandals involving mutual funds.

### B. Benefits of Registration

To stem such problems and concerns, the SEC staff believes that investment adviser registration will be the most effective tool to monitor the hedge fund industry without interfering with a hedge fund manager’s investment strategy. According to Mr. Roye, the benefits of investment adviser registration will be the following:

Information gathering – registration will permit the SEC staff to collect important information about the hedge fund industry.

Examinations – registration will give the SEC the power to conduct examinations of hedge fund managers. By being able to examine fund managers, the SEC staff will be in the position to identify compliance problems ahead of time. Furthermore, the fact that a registered fund manager will be subject to examination is expected to deter wrongdoing.

Screen out “bad apples” – as part of the registration process, a fund manager will have to indicate whether key persons have been subject to felony convictions or disciplinary

action within the financial industry, and therefore the SEC staff would be able to screen out unscrupulous persons from being associated with a hedge fund.

Compliance infrastructure – by requiring hedge fund managers to register with the SEC, such managers will consequently be required to adopt a compliance program pursuant to Rule 206(4)-7 of the Advisers Act.<sup>9</sup> As a result, the SEC staff expects a compliance culture to develop within the hedge fund industry.

Raise investor suitability standards – registration as an investment adviser will subject registered hedge fund managers to the prohibition against charging performance fees or allocations except to investors who satisfy the “qualified client” criteria.<sup>10</sup> As a result, a hedge fund manager that operates a fund exempt from registration pursuant to Section 3(c)(1) of the Company Act, and that charges a performance fee or allocation will be required to require investors to satisfy the qualified client standard in addition to the accredited investor standard as defined in Rule 501(a) of Regulation D promulgated under the Securities Act of 1933, as amended.

Close the “loophole” of Rule 203(b)(3)-1 of the Advisers Act – the adoption of proposed Rule 203(b)(3)-2(a) will close the loophole that permits an adviser to a fund to treat the fund as one client even though such a fund has “thousands” of investors and therefore to remain unregistered. By requiring fund managers of “private funds” to look through the “private fund” to determine whether registration is required will result in operators of funds that have a significant number of investors to register while those fund operators that cater primarily to “friends and family” will presumably remain unregistered.

### **Other Comments Made**

Commissioner Campos and Mr. Roye noted alternative proposals to registration that were ultimately rejected by the SEC staff including the establishment of a registry whereby hedge fund managers would file notice and file annual financial statements as a means for the SEC staff and the public to obtain more data about hedge fund managers. Commissioners Glassman and Atkins also acknowledged that there is an information void about hedge funds but both advocated further exploring the adoption of a registry as a means to monitor hedge funds.

Commissioners Glassman and Atkins both questioned the effectiveness of registration as a means to deter and to detect fraud committed by hedge fund managers. Commissioner Glassman noted that market timing and late trading was not initially detected by SEC

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<sup>9</sup> See Securities and Exchange Commission; “Compliance Programs of Investment Companies and Investment Advisers”; final rule. 68 Fed. Reg. 74714-74730 (December 24, 2003).

<sup>10</sup> See Rule 205-3 of the Advisers Act. Qualified clients are *inter alia* investors with a net worth of at least \$1.5 million or who have invested at least \$750,000 in the fund; investors that are “qualified purchasers” as defined in Section 2(a)(51)(A) of the Company Act; or if the investor is a 3(c)(1) fund, a registered investment company or a business development company, then each beneficial owner of such fund must satisfy being a “qualified client”. *Note that current investors that are not qualified clients in an existing hedge fund will be grandfathered to permit them to remain invested in such a fund.*

staff inspections but rather alluded to another governmental agency, i.e., the New York State Attorney General's office, as having brought these violations to light.

Another critique made by Commissioners Glassman and Atkins is that the adoption of the final rules is a unilateral action made by the SEC without fully consulting with other members of the President's Working Group on Financial Markets.<sup>11</sup>

A dissent by Commissioners Glassman and Atkins will accompany the final rules when released.

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If you have any questions or comments regarding the adoption of the proposed rules or compliance with the Advisers Act, please feel free to contact:<sup>12</sup>

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<sup>11</sup> The President's Working Group on Financial Markets is a committee composed of the Secretary of the U.S. Treasury Department, the Chairman of the SEC, the Chairman of the Commodity Futures Trading Commission, and the Chairman of the Board of Governors of the Federal Reserve System. The President's Working Group on Financial Markets was formed in response to the liquidity crisis involving Long Term Capital Management.

<sup>12</sup> For further information about recent rules and developments applicable to registered investment advisers, please see *SEC Releases Proposed Rules to Require Hedge Fund Managers to Register with the SEC; Chairman Donaldson Defends Proposed Rules; SEC Adopts New Rule 204A-1 of the Advisers Act – Registered Investment Advisers Are Required to Adopt a Code of Ethics; Registered Investment Advisers Are Now Expected to Retain E-Mail; SEC Permits Registered Investment Advisers to Provide Past Specific Recommendations in Response to Unsolicited Requests for Information; SEC Adopts Final Rules Requiring Registered Investment Advisers to Implement Written Compliance Program; SEC Adopts Amendments to Custody Rule under Investment Advisers Act of 1940; and New Proxy Voting Rules and Amendments to Current Rule Requiring Registered Investment Advisers to Maintain Certain Books and Records under the Investment Advisers Act of 1940*, available on our website.