

Articles

"Down for the Count: The SEC Regulates Hedge Funds"

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With the Securities and Exchange Commission's adoption of new rules governing hedge funds^[1], February 1, 2006, has become a date that should be marked on the calendar of every hedge fund manager in America. The centerpiece of the new rules is an amendment to the Investment Advisers Act of 1940 that will require most hedge fund managers to register as investment advisers with the SEC by that date. Until now, most hedge fund managers have been exempt from such registration. Faced with an impending registration requirement, hedge fund managers must determine if and how the new rules apply to them.

The Advisers Act requires any investment adviser with at least \$25 million in assets under management to register with the SEC unless the adviser has had fourteen or fewer "clients" in the past twelve months, does not hold itself out to the public as an investment adviser, and does not advise a registered investment company^[2]. The SEC previously considered a hedge fund to be a single client for purposes of the registration exemption, meaning an investment adviser was not required to count the individual investors in the hedge fund^[3]. Hedge funds themselves are usually organized so as to be exempt from registration under the Investment Company Act of 1940 by taking advantage of an exemption for investment companies with a certain number or type of investors. The combination of these exemptions under the Advisers Act and Investment Company Act allowed hedge fund managers to operate without being subject to the rules governing registered investment advisers. All investment advisers, however, were always subject to certain securities laws, including laws against fraud.

The new rules eliminate the "fund as the client" concept and require hedge fund managers to "look through" the fund to count individual investors as clients. But for hedge fund managers, counting investors is no simple task. Aside from individuals, investors in the hedge funds include pension plans, family trusts, offshore entities, and even other hedge funds. Complex counting rules, the new concept of a "private fund," and different rules for offshore hedge funds and managers will make it difficult to determine whether some fund managers advise fifteen clients.

The Counting Rules

New Advisers Act Rule 203(b)(3)-2 requires a fund manager to count as clients the shareholders, limited partners, members, or beneficiaries of a private fund (a defined term discussed below) unless the investor is also a "knowledgeable insider" of the fund manager. Generally, knowledgeable insiders are directors, officers, general partners, and certain employees who participate in the investment activities^[4]. While a fund manager may be tempted to make an investor a "knowledgeable insider" to avoid the registration requirement, the Advisers Act prohibits such a tactic^[5]. The fund manager itself does not count as a client^[6].

To count clients, a fund manager must determine the aggregate number of investors it advises. That means the fund manager must count each investor in each fund^[7]. A fund manager cannot avoid registration by managing several funds with fewer than fifteen clients each. However, an investor that invests in multiple funds under the management of the same fund manager will only count as one client under the rule.

The new rules also have specific provisions for the counting of family members as clients. Specifically, the following will be considered one client:

- A natural person;
- His or her minor children;
- His or her relatives, spouse, and relatives of spouse who share the same principal residence; and
- Any accounts or trusts of which the only primary beneficiaries are any of the afore-mentioned persons.

Articles

The new “look-through” provisions also will present unique challenges to funds of hedge funds and the funds in which they invest^[8]. Under the new rules, if hedge fund A meets the “private fund” definition and has an Investor, hedge fund B, that is a fund of hedge funds, hedge fund A must count each investor in hedge fund B as a client for the registration requirement, even if hedge fund B’s investment in hedge fund A is very small. Hedge fund A need not know the identity of the investors, nor will the investors in hedge fund B be considered clients in hedge fund A for any other purpose.

Realizing that the term “client” is used frequently throughout the Advisers Act, the SEC indicated that the definition of client in the new rules would apply only for the purpose of counting clients toward the registration requirement. The new definition of client will not affect a fund manager’s duties or obligations under any other section or rule of the Advisers Act, nor will it apply to the national de minimis standard for state adviser registration.

The Private Fund

Before hedge fund managers could be effectively regulated, the SEC had to address the fact that there is no universally accepted definition of “hedge fund.” Hedge funds are simply a type of investment entity and hedge fund managers are investment advisers that manager those entities. The SEC wanted to create rules to regulate advisers of hedge funds without affecting advisers to other investment entities, such as private equity funds and venture capital funds. The result is the creation of the “private fund,” a term that covers what the SEC considers to be the primary characteristics of virtually all hedge funds.

Under new rule 203(b)(3)-1, a “private fund” subject to the “look-through” rules:

- Is an investment company that is exempt from registration under Section 3(c)(1) or 3(c)(7) of the Investment Company Act;
- Generally allows investors to redeem their interests in the fund within two years of purchasing them; and
- Offers interests based on the “investment advisory skills, ability or expertise of the investment adviser.”

Sections 3(c)(1) and 3(c)(7) of the Investment Company Act are the provisions under which hedge funds generally claim exemption from registration as investment companies. Many commentators have criticized the new rules because funds that rely on 3(c)(1) or 3(c)(7) usually only accept investors that meet a high standard of investment sophistication, such as “accredited investors” or “qualified purchasers.”^[9] Under existing securities laws, these investors are presumed to have enough financial sophistication that they do not need as much protection from the SEC as other investors. However, in the adopting release the SEC refutes this presumption and concludes that someone that invests in a hedge fund is acknowledging their need for expert investment advice.

Redemption Period

The SEC points to a high degree of liquidity as the key distinguishing feature of hedge funds, as opposed to other pooled investment vehicles like private equity and venture capital funds. The SEC considers funds that offer investors the right to redeem their interests on a regular or short-term basis, such as quarterly or monthly, to be more like hedge funds than other types of investment entities.

The SEC distinguishes a redemption, which is a liquidation of the investor’s interest in the fund initiated by the investor, from a distribution, which is a payment of fund assets or income to investors initiated by the fund manager. The two-year redemption period does not apply to distributions. The SEC does not distinguish between U.S. and offshore investors for purposes of the two-year redemption rule. This means that a fund cannot offer a less than two-year redemption period to its non-U.S. investors.

The two-year redemption period applies to each interest purchased or amount of capital contributed to the fund, thus allowing for a “first-in, first-out” determination. An exception to the two-year rule is redemption of interest acquired as result of reinvestment of distributed capital gains or income.

Articles

The SEC also created an exception for redemption rights due to the extraordinary circumstances, which, according to the adopting release, includes the following:

- Events that would make the investment impractical or illegal;
- The investor's death or total disability;
- Death, incapacity, or absence of key personnel at the fund adviser;
- Merger or reorganization of the fund;
- Avoidance of a materially adverse tax or regulatory outcome; or
- Preventing the fund's assets from being considered "plan assets" under ERISA.

Many commentators questioned whether hedge funds would simply require a lock-up period longer than two years to avoid application of the rule. The SEC acknowledged the possibility and stated that it would monitor developments to assess whether the rule continued to adequately distinguish hedge funds from other similar funds. Also, the SEC explicitly noted that fund managers cannot get around the two-year redemption test by using side agreements or letters that provide for a shorter redemption period despite the fund's formal provisions.

The third part of the private fund term is that interests in the fund are offered based on the investment advisory skills, ability, or expertise of the investment adviser. The SEC considers the adviser's (and any subadvisers') history, experience, past performance, strategies, and disciplinary record likely to be important to investors in deciding whether to invest in a fund. A hedge fund manager will not be able to avoid the registration requirement even if the skills, ability, and expertise that attract investors come from a subadviser. The subadviser would have to look through the fund manager to count the clients of the fund for purpose of registration.

The SEC also decided against making an exception for funds that consist of the manager's family members. The Commission opted instead for rules regarding the aggregation of family members for purposes of counting clients.

Offshore Hedge Funds and Advisers

The term "offshore" is a broad generalization of a sector of the hedge fund industry that securities laws treats differently than U.S.-based hedge funds. Under the new rules, "offshore" is generally defined as not having a residence or principal place of business in the United States.

Offshore hedge funds are usually structured as offshore funds whose clients are either U.S. tax-exempt investors or non-U.S. persons, or both, that invest in U.S. securities^[10]. Many offshore hedge funds and their managers are subject to regulation by securities authorities in foreign jurisdictions. Rather than undertake an examination of various foreign jurisdictions in regulating hedge funds and managers, the SEC's rules for offshore hedge funds and managers are aimed at protecting U.S. investors and creating "a level playing field for all market participants." Although many commentators called for offshore funds and managers to be exempt from the new rules, it seems the SEC did not want to allow fund managers to avoid registration by setting up a fund or manager abroad.

Offshore hedge funds frequently employ a "master and feeder fund" structure, where an offshore fund manager advises a "master" fund, usually also set up offshore. The investors in the master fund are "feeder" funds that solicit capital from investors. Feeder funds may be set up in the United States, offshore, or often both, but feeders that seek investment from U.S. investors will usually be set up in the United States.

For master-feeder funds, the fund manager must look through any feeder funds to count U.S. investors. The fund manager need not count the non-U.S. investors, a status determined based on:

- For individuals, the place of residence;
- For business entities, the principal place of business;
- For personal trusts and estates, in accordance with the rules set forth in Regulation S; and

Articles

- For discretionary and non-discretionary accounts managed by another investment adviser, the location of the person for whose benefit the account is held.

The residence of an investor is determined at the time of investment. If an offshore investor moves to the United States after the investment is made, the fund manager will not be required to count the investor as a client for registration purposes. Also, for purposes of the assets under management test, the assets of offshore investors need not be counted.

The U.S. investor rule only applies to a privately held offshore funds. An offshore fund that is publicly offered outside the United States and regulated as a public investment company in another jurisdiction would not have to register as an investment adviser, even if it had fifteen or more U.S. investors. This exception follows the reasoning of the SEC in the Touche Remnant & Co. and Goodwin Proctor & Hoar no-action letters^[11]. Several commentators noted that the concept of a publicly offered security differs among jurisdictions. Additionally, being listed on a foreign securities exchange is no guarantee that the fund has met the requirements of being considered “publicly offered” in that jurisdiction. Whether a fund is publicly offered in a foreign jurisdiction is an issue that will be determined on a case-by-case basis.

Under the new rules, offshore fund managers of private offshore funds must register as investment advisers unless they qualify for an exemption. The SEC noted that U.S. investors can acquire interests in offshore funds that have little connection to the United State other than the investors or perhaps the securities in which the funds invest. The SEC acknowledged that application of the entire Advisers Act in such a case was unnecessary. Thus, the new rules provide that registered offshore fund managers will be able to treat the fund as a client for many provisions of the Advisers Act. Assuming the fund manager has no other U.S. clients, treating the fund as the client will enable the fund manager to avoid several of the Advisers Act rules^[12]. However, the fund manager will still be subject to the fraud provisions, books and records rules, and staff examination provision of the Advisers Act^[13].

What's Next?

There are other issues outside the context of the registration requirements. Two of the SEC's five commissioners issued a stern dissent along with the adopting release, questioning the Commission's reasons for adopting the new rules and raising doubt about the need for registration of hedge fund managers altogether. There are questions about whether the SEC even has the legal authority to make these amendments to the Advisers Act without the direction or approval of Congress.

Assuming the rules do not change before they become effective, or are not struck down by a legal challenge, hedge fund managers will need to prepare to meet the new requirements. Among the concerns for fund managers will be:

- Having an effective Form ADV on file with the SEC by February 1, 2006, and understanding the updating and delivery requirements of the Advisers Act;
- Developing written compliance policies and procedures, including appointing or hiring a compliance officer;
- Determining whether investors are “qualified clients” under Advisers Act Rule 205-3 so the fund manager is eligible to charge performance fees; and
- Complying with rules governing the use of advertising, custody of client assets, and payment to solicitors.

Registration under the Advisers Act also will subject fund managers to the prospect of unannounced examinations by the SEC staff. Fund managers that have not been maintaining books and records in accordance with the Advisers Act will have to develop policies and dedicate staff to ensure proper documentation.

The new rules are certain to impose a substantial burden on both the SEC and hedge fund managers. Hedge fund managers have a little more than a year to understand, prepare, and comply with the new rules. At the same time, the SEC will be preparing for the potential wave of new filings, examinations, and possibly enforcement actions. No one doubts that these rules will set the hedge fund industry on a new course. The question is whether it is headed in the right direction.

Articles

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[1] SEC Release No. IA-2333 (Dec. 2, 2004), available at www.sec.gov/rules/fial/ia-2333.htm;

[2] See Section 203(b)(3) of the Investment Advisers Act. This is not the only exception from registration. See Section 203(b) of the Advisers Act.

[3] See SEC Release No. IA-983 (July 12, 1985).

[4] See Rule 205-3(d)(iii) of the Advisers Act.

[5] See Section 208(d) of the Advisers Act.

[6] Similarly, under the new rules, the assets of the knowledgeable insiders and the investments of the fund manager's family are not counted to determine whether the adviser has the requisite \$25 million of assets under management to register under the Advisers Act.

[7] Note that this look-through provision is different from the look-through provisions contained in the Investment Company Act. See Section 3(c)(1) and 3(c)(7) of the Investment Company Act.

[8] Funds of hedge funds are hedge funds that invests their assets in other hedge funds.

[9] "Accredited Investor" is defined in rule 501 of the Securities Act. "Qualified Purchaser" is defined in Section 2(a)(51) of the Investment Company Act.

[10] See "Implications of the Growth of Hedge funds, Staff Report to the United States Securities and Exchange Commission," (Sept. 2003), available at www.sec.gov/news/studies/hedgelfunds0903.pdf;, at ix.

[11] See Touche Remnant & Co., SEC Staff No-Action Letter (Aug. 27, 1984), and Goodwin, Procter & Hoar, SEC Staff No-Action Letter (Feb. 28, 1997).

[12] For example, Rule 206(4)-7 [compliance policies, procedures, and officer requirements], Rule 206(4)-2 [custody rule], and Rule 206(4)-6 [proxy voting rules] would not apply.

[13] See Section 203(b) [registration], and Section 204 of the Advisers Act. Additionally, the fund manager will be required to register under the Advisers Act if it advises fifteen or more U.S. clients in accordance with the provisions of the advisers Act.