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# Securities Law Developments

 NEWSLETTER

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## SEC Staff Report on Hedge Funds

The report of the Securities and Exchange Commission's Division of Investment Management entitled "Implications of the Growth of Hedge Funds,"<sup>1</sup> released on 29 September 2003, has confirmed the suspicions of many by advancing a recommendation that the SEC consider requiring the registration of all hedge fund advisers under the Investment Advisers Act of 1940 (the "Advisers Act"). Contrary to some expectations, the report does not recommend raising the bar for "accredited investor" status. It does, however, provide a thorough discussion of the state of the industry and applicable laws and regulations, and identifies in detail the Division's concerns and recommendations relating to hedge funds.

### Background

Recent significant growth in both the number of hedge funds and their assets under management, propelled largely by the increased interest of institutional investors seeking investment vehicles with absolute return strategies, has focused attention on this area of the alternative investment market. In June 2002, concerns stemming from this growth led the Division to commence a study of the hedge fund industry, punctuated in May 2003 by the SEC's Hedge Funds Roundtable. The Roundtable brought many industry representatives and others together for discussion and generated approximately 80 comment letters to the SEC, which the Division considered in preparing the report.

The report highlights Division concerns that there is a lack of both regulatory oversight in this area and direct

information about the hedge fund industry available to the SEC. While the Division concedes that there is no evidence that hedge funds or hedge fund advisers are disproportionately involved in fraudulent activities, the Division asserts that the SEC is in a "wait-and-see" position in instances of fraud or other misconduct and is reliant on the anti-fraud provisions of the federal securities laws as after-the-fact enforcement mechanisms. The Division also asserts that it is unclear whether sufficient material information is available to hedge fund investors to assist them in making fully informed decisions.

The report also identifies other concerns:

- In the Division's view, the lack of independent checks of hedge fund advisers' valuation of portfolio securities, coupled with their broad discretion in valuation and powerful incentives to report superior performance, raises questions about the quality and fairness of the prices at which investors buy or redeem their interests;
- In the Division's view, the increased involvement of institutional investors, as well as the growing number of retail investors who can reach "accredited" status (see below) raises the issue of "retailization" of hedge funds. The report concedes, however, that there is no evidence of significant direct retail investment in hedge funds, and the Division's concern appears to be focused instead on investments by registered funds of hedge funds which are regulated by the Commis-

<sup>1</sup> <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

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sion and by pension plans and other large, sophisticated investors;

- In the Division's view, although hedge fund advisers generally provide investors with private placement memoranda ("PPMs"), investors may not consistently receive sufficient disclosure relating to the adviser and its management of the fund, in particular about material changes to the adviser's management;
- In the Division's view, conflicts of interest arising from an adviser's management of multiple hedge funds and the opaque nature of a hedge fund adviser's arrangements with its prime broker may work to investors' detriment. For example, hedge fund advisers rarely disclose the nature of the services they receive from prime brokers or how they compensate the prime broker, and may not be disclosing that those fees could include amounts for services that do not benefit investors;
- In the Division's view, some participants in the hedge fund industry may not be complying with the prohibition on general solicitation in offers and sales of hedge fund securities, particularly in light of the extensive use of the Internet and the proliferation of public information about hedge funds.

#### **Requiring Hedge Fund Managers to Register Under the Advisers Act**

Currently, hedge fund advisers are generally exempt from registration under the Advisers Act if they have had fewer than 15 clients in the preceding 12 months, do not hold themselves out generally to the public as investment advisers and are not investment advisers to a registered investment company. Under SEC Rule 203(b)(3)-1, a "legal organization" may be counted as a single client if it receives investment advice based on its investment objectives rather than on the individual investment objectives of its owners. As a result, many hedge fund advisers are not required to register. Many nonetheless register voluntarily, either because investors demand it or for competitive reasons.<sup>2</sup>

The Division's primary recommendation is that the SEC consider amending Rule 203(b)(3)-1 to require hedge fund advisers to "look through" any hedge funds they manage and count each separate investor as a client. Effecting compulsory registration would, the report submits, achieve multiple benefits, namely:

- The institution of periodic SEC examinations would lead to a "compliance culture" and earlier detection of fraud and other misconduct;
- The potential of surprise examinations and the deployment of deficiency letters further encourages a compliance culture;
- The collection of "basic and meaningful information" on these funds by the SEC above and beyond that currently provided by private organisations. This information could include the number of hedge funds the adviser manages, the amount of assets and the identities of the advisers' controllers;
- Advisers could be required to make disclosures to investors and to the SEC, including disclosures regarding business practices and disciplinary histories;
- These disclosures could include conflicts of interest, such as those engendered by the side-by-side management of hedge fund and other types of funds, as well as those regarding prime brokerage relationships;
- Registration also would compel advisers to maintain specified books and records; and
- Registration would effectively raise the bar for minimum investment because registered investment advisers are, in general, prohibited from levying performance fees unless the investor has \$750,000 invested or a net worth of \$1.5million.<sup>3</sup>

<sup>2</sup> Roughly 48 percent of the advisers surveyed for the report were registered with the SEC. One comment letter received by the SEC states that due to market forces driven by trust and ERISA fiduciaries, hedge funds are finding it necessary to register in order to attract capital from that segment of the market. Another suggested that recent well-publicized fraud cases led investors to demand the assurances provided by registration.

<sup>3</sup> Presently, hedge funds selling interests through private offerings in general seek to fall within a safe harbor under the Securities Act of 1933 which allows sales to "accredited investors" with a minimum single annual income of \$200,000, joint spousal income of \$300,000, or a net worth of \$1 million. The Advisers Act prohibits registered advisers from charging performance fees to hedge funds relying on Section 3(c)(1) of the Investment Company Act unless all of the fund's clients are "qualified clients" meeting the higher threshold of a \$750,000 investment or a net worth of \$1.5 million.

## **What Would Registration Mean in Practice?**

The report maintains that Advisers Act registration will not impede hedge fund operations. At present, advisers registering with the SEC are required to file Form ADV, update the filing when required by SEC rules, and periodically provide investors with the disclosures required at Part II of the form. Registered advisers must maintain required books and records and submit to periodic examinations by the SEC's Division. They also must comply with other requirements, such as safeguarding of client assets and informing clients of their adverse financial condition.

## **Other Recommendations**

Although the report's primary recommendation is the one likely to cause the biggest flurry of activity, others also are significant:

### ***Provision of Hedge Fund Brochures***

The report recommends that the SEC amend its rules to require hedge fund advisers to provide a disclosure statement tailored to hedge funds. This might include disclosure about various conflicts of interest, risk management measures, valuation procedures, and lock-up periods. Requiring that this information be provided in the adviser's brochure would have the purported benefit of requiring advisers to update their disclosures periodically and make that information available to investors.

### ***Requiring Registered Investment Companies to Follow Board-Adopted Valuation Procedures***

The report recommends that the SEC consider rulemaking to address the valuation of portfolio holdings by registered investment companies (including registered funds of hedge funds) that invest their assets in hedge funds. Specifically, the Division recommends a rule prohibiting registered investment companies from investing in securities of hedge funds unless their boards of directors have adopted procedures designed to ensure that the funds value those assets consistently with the requirements of the Investment Company Act. (Given the SEC's extensive authority over registered investment companies, it is unclear why such a rule is necessary, however.)

### ***Additional Disclosure in Relation to Fees of Funds of Funds***

The report recommends that the SEC adopt its recently-proposed rule requiring registered investment companies that invest all or substantially all their assets in hedge funds to make additional disclosures in relation to the underlying funds' fees and expenses, so that investors would receive

disclosure of expenses of both the fund in which the investor invests and of the underlying funds.

### ***Monitoring Capital Introduction Services Provided by Prime Brokers***

The Division is concerned that many advisers may not disclose that fees paid to prime brokers may include amounts for services that do not benefit investors. In particular, the report recognizes that prime brokers who provide capital introduction services to hedge fund advisers often invite these investors to attend capital introduction conferences and seminars (also referred to as "dating service" activities). The report recommends that the SEC monitor closely prime brokers' capital introduction practices.

### ***Public Solicitation***

Conversely, one area in which the report recommends removing a regulatory burden on hedge funds is its recommendation that the SEC consider permitting general solicitation in offerings by funds relying on Investment Company Act section 3(c)(7). The report recognizes that these funds can be sold to an unlimited number of investors so long as they are "qualified purchasers," whom the report acknowledges are "highly sophisticated." As a result, the report concludes that permitting general solicitation amongst this group would not raise any investor protection concerns. If adopted, this would allow considerably greater leeway to section 3(c)(7) funds and their advisers in marketing their offerings. The recommendation is somewhat puzzling, however, given that the prohibition appears in the statute itself and would thus appear to require Congressional action — and not merely SEC rulemaking — to amend.

The report also recommends:

- That examination staff of the NASD and the SEC continue to be vigilant in identifying any violations of broker-dealer suitability obligations;
- That the SEC encourage the hedge fund industry to embrace existing best practices; and
- That the SEC consider issuing a Concept Release for examining wider use of hedge fund investment strategies in registered investment companies.

### ***Will the Proposals Affect Investment Strategies?***

The report does not propose any interventionary or supervisory measures applicable to strategies or their constituent parts (shorting, leverage, the use of deriva-

tives, etc.). Nor does the report seek to require the disclosure of proprietary trading strategies. The report does not amount to an attack on the funds themselves, and emphasises their utility in encouraging innovative investment strategies, market efficiencies and liquidity, and enhancing the risk management opportunities available to other ‘mainstream’ market participants.

### Concerns About Mandatory Registration

The report recognizes that the additional costs associated with registration, coupled with additional recordkeeping systems requirements and ongoing regulatory compliance, may prove burdensome for many, but concludes that the benefits of registration outweigh the additional costs that would be imposed on currently unregistered hedge fund advisers. The report also recognizes that the SEC may need to evaluate its resources and capabilities and modify its existing investment adviser examination program to account for the unique nature of hedge fund advisers. In addition, at the SEC’s press conference unveiling the report, there was discussion as to whether new registration requirements might lead to the migration of funds offshore, or whether there is any cause to believe that such registration will inhibit innovation and originality as more ambitious strategies are curbed.

Given that the report concedes that most of the increased investment in hedge funds is coming from sophisticated institutional investors, and that hedge funds are not disproportionately subject to fraud, the public policies supporting mandatory registration are far from clear. In addition, the Division’s recommendation runs contrary to 70 years of securities law precedent recognizing that transactions and contracts among sophisticated participants do not require federal oversight. Finally, at a time when the SEC’s ability to police illegal conduct by registered mutual funds and broker-dealers is increasingly in question, it seems ironic that the agency would seek to extend its jurisdiction to protect the wealthy and sophisticated.

### Conclusion

The report provides a useful summary of the law pertaining to the hedge fund industry and of information regarding industry practices. The recommendation most likely to cause a stir, and perhaps also most anticipated, is that of mandatory registration. As to the likelihood of implementation of that recommendation, although the SEC has concerns in relation to this very successful growth area, as discussed at the Roundtable earlier this year, recent comments have suggested that it may take the view that mandatory registration may well dilute its resources away from those more in need of the SEC’s protection. Indeed, the somewhat ambivalent wording of the staff’s recommendation — that “the Commission should consider requiring hedge fund advisers to register as investment advisers under the Advisers Act, taking into account whether the benefits outweigh the burdens of registration” — suggests that there will be much debate within the agency before any final action is taken.

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