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January 2005 - Hedge Fund Redux - Registration Required for Fund Advisers

A “hedge fund” is a pooled investment vehicle typically organized, for tax purposes, as a pass-through entity such as a limited partnership or limited liability company. A hedge fund is not an “investment company” subject to registration under the Investment Company Act if, among other things, it has fewer than 100 equity owners and does not engage in a public securities offering.

Hedge funds employ aggressive trading strategies, like short-selling and the use of leverage, to offset unfavorable movements in the equity markets and thus “hedge” their portfolios. Hedge funds often invest in securities with little or no market correlation, the better to capitalize on the assumed superior acumen of their advisers. By contrast, traditional investment vehicles, such as mutual funds, are thought to present fewer opportunities for extraordinary gains because they invest conservatively in listed securities the prices of which have already been discounted to reflect all publicly available information.

Prior to December 2, 2004, a hedge fund *adviser* was exempt from registration under the Investment Advisers Act if, among other things, it did not advertise publicly, did not advise a registered investment company and had fewer than 15 “clients” during the preceding 12 months. The Advisers Act Rules treated the fund itself as a single “client” if the adviser was guided by the fund’s investment objectives, not those of its individual owners. Moreover, if the adviser was not registered, the owners could be charged incentive or “performance fees,” usually 20% of the fund’s portfolio return, in addition to general management fees. By contrast, *registered* advisers can charge such fees only to “qualified owners” who invest at least \$750,000 with the adviser or have a net worth of \$1.5 million. Not surprisingly, many securities professionals abandoned main stream Wall Street firms to form and become unregistered advisers to private hedge funds. They were widely perceived as the avant-garde of a new class of bold and talented managers whose funds would substantially outperform the market. In response, investors, whether or not “qualified,” flocked to these funds and willingly paid the performance fees.

The practical result of this scheme was that the federal registration requirement was a dead letter for any adviser willing and able to forego public advertising and raise hedge fund capital through exempt securities offerings. These “private” advisers could, without SEC oversight, organize, impose investment objectives upon, perform advisory services for and collect performance fees from up to 15 private, 99-owner funds to which billions in capital had been contributed.¹

This situation did not sit well with Chairman Donaldson and Commissioners Campos and Goldschmid. On July 20, 2004, they proposed to amend the client definition Rule and adopt a related Rule formally defining the term “private fund.” An adviser to a “private fund” would be

¹ An adviser is ineligible and *prohibited* from registering with the SEC if it is required to register in the state in which it maintains its principal offices and has less than \$25 million under management. This reflects an Advisers Act allocation of oversight responsibility for small advisers between the SEC and the states. An adviser subject to state registration may register *voluntarily* with the SEC if it manages between \$25 and \$30 million and it *must* register if it is not otherwise exempt and manages more than \$30 million. At the state level, the client limit for exemption purposes is typically 5 or fewer. As a result most “private” hedge fund advisers are registered with at least one state securities authority.

required to count as a separate “client” each fund owner (including each investor in an owner organized as a private entity or registered investment company) unless the owner participated in the investment activities of the adviser as a director, officer or supervisory employee.

A “private fund” was to be defined as one (a) that was not an investment company because it lacked the requisite number of owners (b) that sold its ownership interests by touting the “investment advisory skills, ability or expertise” of the adviser and (c) that permitted the normal course redemption of those interests within two years. The two-year lock up was inserted to distinguish hedge funds from private equity funds that are similar in many respects but require longer term investments. (For now, apparently, private equity funds will be left alone.) The lock-up provision would not apply to permitted redemptions triggered by extraordinary events such as an adverse tax ruling or the death or disability of an owner.

On December 2, 2004, the proposal was adopted by a three-to-two vote. The proposal included an amendment of the performance fee Rule that allows existing non-qualified owners to retain or even add to their investments while continuing to pay a performance fee, but this relief will be moot for advisers in states that continue the original prohibition without grandfathering. New record keeping, asset protection and compliance standards were also adopted and Form ADV, the registration form for advisers, was amended to align its disclosure requirements with the other changes. The new registration provisions take effect in phases beginning February 10, 2005. As a result, “private” advisers must now register unless they are ineligible, manage less than \$30 million, or can claim one of the limited exemptions for special categories of advisers.²

The proposal was adopted in the face of widespread opposition from the business and financial communities and a vigorous dissent by Commissioners Atkins and Glassman. In general, the minority thought expanded registration was not justified by adviser misconduct, that the SEC had adequate means at its disposal to monitor the hedge fund industry and that the substantially increased filings and administrative burden caused by the amendments would overwhelm the SEC staff, diverting it from more pressing duties. The majority asserted that, in light of the growth of hedge funds and the disciplinary history of some advisers, federal registration is necessary and will be cost effective. The majority brushed aside the question of how registration would actually affect advisers and their investors, stating simply that the Advisers Act “does not impose a detailed regulatory regime.” Perhaps not, but it imposed no regime at all on private advisers until the majority acted. It remains to be seen what “details” will follow.

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² See, Rule 203(b)(3)-1 and note 1. The Adopting Release is No. IA-2333 dated December 2, 2004. The special exemptions cover advisers all of whose clients are residents of a single state or are insurance companies, advisers organized as charities or church plans and advisers registered with the Commodity Futures Trading Commission. The general prohibition against performance fees is contained in Section 205(a) of the Advisers Act. The exemption for “qualified clients” is created by SEC Rule 205-3. See also, “*Legal Bulletin - August 2004 - Hedge Fund Alert*” at www.hutchins-law.com/publications.