

Financial Technologies Forum LLC

HEDGE FUND COMPLIANCE & RISK

***SEC Registration of Hedge Fund Managers:
Current Law and Proposed Legislation***

December 2, 2009

Jeffrey B. Cobb, Esq.

Cobb & Associates PC

jcobb@ehedgelawyers.com

www.hedgelawyers.com

Westport Financial Center

191 Post Road West

Westport, CT 06880

(203) 221-2700

SEC Registration of Hedge Fund Managers: Current Law and Proposed Legislation: Summary of Presentation

- When is SEC registration as an investment adviser required under current law (Investment Advisers Act)
- Review of basic exemptions from advisory registration
- Exclusions that permit voluntary registration
- When a hedge fund manager may wish to consider voluntary registration
- Summary of the current key House bill: the Private Fund Investment Advisers Registration Act of 2009 (HR 3818)
- Summary of the current key Senate bill (discussion draft): The Restoring American Financial Stability Act of 2009, introduced by Sen. Dodd
- Rationale and impact of the House and Senate Bills
- Forecast as to the course of registration requirements

SEC Registration of Hedge Fund Managers: Current Law and Proposed Legislation: When SEC Registration is Required Under Current Law

- Typical hedge fund manager meets investment adviser definition under Investment Advisers Act of 1940 (the “Advisers Act”): person “in the business as to advising others with respect to purchasing securities...”
- However, the manager will not be required to register unless it meets both of two tests: An “assets test” and a “client test”
- Under the assets test, the manager will not be required to register unless it has at least \$30 million in AUM
- Under the client test, the manager will not be required to register unless it has at least 15 “clients” in any 12-month period (assuming it is not “holding itself out”)
- These tests summarized in following slides

SEC Registration of Hedge Fund Managers: The “Assets Test” Under the Advisers Act

- The Assets Test is satisfied if the manager has at least \$30 million in AUM (Rule 203A-1)
- Test need not be required if the state doesn't have an advisory registration statute- but this is only Wyoming
- However, “AUM” here is a term of art. It requires:
- “Continuous and regular supervisory or management services” (generally, investment discretion) over
- “Securities portfolio(s).” This is defined as an account with at least 50% in total value consisting of securities.
- Certain assets “may” be treated as securities, e.g., cash
- See Instructions to Form ADV and SEC interpretations

SEC Registration of Hedge Fund Managers: The “Client Test” Under the Advisers Act

- Even if the fund manager meets the \$30 million AUM test, it will not be required to register under the Advisers Act if it meets the so-called “private adviser” exemption (Section 203(b)(3)(the “Client Test”).
- Under the Client Test, an adviser is exempt from SEC registration if (i) it has fewer than 15 clients in any 12-month period and (ii) does not “hold itself out to the public” as an investment adviser
- As a result of the Goldstein v. SEC case (2006), the hedge fund itself, not the investors, is the client (assuming individualized advice is not offered to the investors). Court relied upon plain meaning of “client”.
- Accordingly, currently a manager could have up to 14 funds (and managed accounts) before being required to register.

SEC Registration of Hedge Fund Managers: Exclusions Permitting Voluntary Registration Under the Advisers Act

- To summarize, advisers having at least \$30 million in AUM and at least 15 clients are required to register with the SEC. When may an adviser register voluntarily?
- To be permitted to register voluntarily, an adviser must have at least \$25 mm in AUM, unless it meets one of the permitted categories in Rule 203A-2.
- Most relevant of these categories are “pension consultants”(i.e., advising at least \$50mm in pension plans), parties with affiliated entities that are SEC registered and multi-state advisers.
- An adviser is permitted to register, however, if it has a “reasonable expectation” of meeting these eligibility requirements within 120 days following registration.

SEC Registration of Hedge Fund Managers: When May a Hedge Fund Manager Consider Voluntary Registration Under the Advisers Act?

- ERISA Eligibility. If a hedge fund manager wishes to manage ERISA assets (either within his fund, assuming the “25% test” is exceeded, or on a managed account basis), he must be a “qualified manager”, which requires state or SEC advisory registration. Moreover, most managers (or their brokers) want the protections of the “QPAM” exemption, which requires SEC registration.
- Client Requirements. Some institutional investors, such as funds of funds for emerging managers, require that their managers be SEC registered.
- Foreign Jurisdictions. Certain foreign countries on which funds may be focused may offer lesser regulation upon SEC-registered managers.
- Imprimatur Issues. Whether SEC registration confers the impression of higher compliance standards.

Legislative Proposals During 2009 Regulating Hedge Fund Managers: A Brief Overview

- In January 2009, Sens. Grassley and Levin introduced the Hedge Fund Transparency Act of 2009, which would require the registration of hedge funds with over \$50 million in assets to register with the SEC. interestingly, this may be the only bill that required registration of the fund, not the manager. Gained little support.
- In June 2009 the Obama administration released a comprehensive legislative package for financial regulatory reform Title 4 of the Bill, labeled the Private Fund Investment Advisers Registration Act of 2009 (the “Obama Bill”) would abolish the existing “private adviser” exemption as to hedge funds, while preserving the existing \$30 million asset test.

Legislative Proposals During 2009 Regulating Hedge Fund Managers: A Brief Overview (cont'd)

- The Obama Bill would also impose enhanced recordkeeping and reporting requirements aimed toward enabling the SEC to improve and monitor market stability.
- On October 1, 2009, Rep. Kanjorski introduced a modified version of the Obama bill, also known as the Private Fund Investment Advisers Registration Act of 2009 (H. R. 3818).
- On October 27, 2009, H.R. 3818, with modifications, was approved by the House Committee on Financial Services, by a 67-1 vote (the “House Bill”).
- On November 16, 2009, Senator Dodd introduced a revised discussion draft of a comprehensive financial regulatory reform bill, known as The Restoring American Financial Stability Act of 2009 (the “Senate Bill”).

Legislative Proposals During 2009 Regulating Hedge Fund Managers: The House Bill--Summary of Key Provisions Affecting Hedge Fund Managers

- “Private funds” defined as 3(c)(1) or 3(c)(7) funds.
- The House Bill, like the Obama bill, would abolish the existing exemption for “private advisers”. Accordingly, there would no longer be a “client test” for U.S. managers and technically the manager of a single hedge fund could be required to register.
- However, a key distinction in the House Bill is that it would vastly liberalize the assets test. Specifically a private fund manager would not have to register if each of such funds had assets under management in the U.S. of less than \$150 million (as compared with \$30 million under current law). Note that the exemption is a US fund test, not an aggregate test.

Legislative Proposals During 2009 Regulating Hedge Fund Managers: The House Bill--Summary of Key Provisions Affecting Hedge Fund Managers (cont'd)

- Managers relying upon this \$150 million exemption, however, would be required to maintain records and furnish reports (not specified) as the SEC determines to be “necessary or appropriate” in the public interest.
- The House Bill provides the SEC with authority to register and examine advisers to “mid-sized private funds” to the extent of reflecting “systemic risk” posed by such funds. A “mid-sized fund” is not defined.
- Registered advisers will be subject to additional reporting, including reports to investors and potential investors, as the SEC may prescribe.
- “Foreign private advisers” and advisers to “venture capital funds” (to be defined by the SEC) would be excluded from registration.

Legislative Proposals During 2009 Regulating Hedge Fund Managers: The Senate Bill--Summary of Key Provisions Affecting Hedge Fund Managers

- Similar to the Obama and House Bills, the Senate Bill would abolish the private adviser exemption or client test.
- However, like the House Bill, the Senate Bill would substantially increase the assets test, although not as liberally. Under the Senate Bill, a private fund manager would not have to register if they managed less than \$100 million in the aggregate.
- The Senate Bill in some respects would have greater reporting requirements for registered advisers than the House Bill, e.g., the filing of various documents, including side letters.

Legislative Proposals During 2009 Regulating Hedge Fund Managers: Rationale for the Regulatory Changes

- Key themes of these bills is to require the SEC to focus upon systemic risk that affects the broader financial markets and upon increased investor disclosure.
- A number of factors contributed to the vastly increased asset tests for private fund managers: (i) the focus upon the largest firms most likely to have systemic impact; (ii) the abolition of the private adviser test; (iii) appreciation of the costs and burdens of registration and attendant compliance; and (iv) the perception that the limited resources of the SEC should be concentrated upon the larger firms entailing greater systemic risk.
- Difficult to predict how heavily these bills will be modified, if passed at all; however, the bills are largely similar in their major provisions. Bills do contain provisions allowing time to prepare for registration.