PUBLICATION

Proposed Regulation of Hedge Fund and Private Equity Fund Advisers

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On July 15, 2009, the Obama administration delivered to Congress proposed legislation to require all investment advisers to private funds (i.e., pooled funds exempt from registration under the Investment Company Act) with more than $30 million under management to register with the SEC. The newly registered advisers would be subject to existing regulations under the Investment Advisers Act (the "Act"), as well as proposed amendments to the Act that apply only to the advisers of private funds.

Regulatory Exemptions

Currently, virtually no investment advisers to private funds (commonly known as hedge funds or private equity funds) register with the SEC under the Act. They rely on the exemption under Section 203(b) of the Act for an investment adviser that has had fewer than 15 clients in the last 12 months and that neither holds itself out to the public as an investment adviser nor acts as an adviser to any investment company, such as a mutual fund, registered with the SEC under the Investment Company Act. Hedge funds and other private equity funds commonly avoid registration under the Investment Company Act by relying upon the exemptions under Section 3(c)(1) for funds with fewer than 100 beneficial owners that have not made a public offering or under Section 3(c)(7) for funds made up exclusively of "qualified purchasers" that have not made a public offering.

History of Fund and Investment Adviser Regulation

In 1998 the hedge fund industry came to national attention with the failure of Long-Term Capital Management, a Connecticut-based hedge fund that had more than $125 billion in assets under management. As a result of this failure, the SEC began a comprehensive study of the United States hedge fund industry. In September 2003, the staff of the SEC released a report titled "Implications of the Growth of Hedge Funds" (the "Report"). The Report noted the following concerns resulting from the lack of SEC oversight on hedge funds:

- the inability to detect fraud at early stages
- the lack of meaningful information about hedge funds and hedge fund advisers
- the lack of independent verification on the hedge fund's valuation of its securities
- an increase in the number of retail investors who met the standard of "accredited investor"
- an increase in individual investor exposure to hedge funds through pension plans, endowments, foundations and other charitable organizations

As a result of the Report, the SEC introduced a series of rules that were collectively known as the "Hedge Fund Rule." The first rule redefined an investment company to include any company or vehicle of pooled funds that (a) was exempt from registration under the Investment Company Act by virtue of having fewer than 100 investors or only qualified investors; (b) permitted its investors to redeem their interests within two years of investing; and (c) marketed itself on the basis of the "skills, ability or expertise of the investment adviser."

The second rule required that each investment adviser count as a client any shareholder, limited partner, member, or beneficiary of any fund that the investment adviser managed for the purposes of complying with the investor quantity limitations. This meant that the term "client" would now be interpreted to mean "investor." Since investment advisers had previously counted each pool of capital as one "client," in effect, this rule meant

that the number of clients each investment adviser advised had instantly increased such that no investment adviser could meet the "private issuer exemption" or the "15 client" exemption provided by Section 203(b) of the Act. The rules would require each investment adviser to register with the SEC by February 1, 2006.

Prior to the effective date of these rules, an investment advisory firm owned by Phillip Goldstein challenged the second part of the "Hedge Fund Rule" which equated "client" with "investor" in the United States Court of Appeals for the District of Columbia Circuit. Goldstein argued that the SEC exceeded its statutory authority in adopting the Hedge Fund Rule and that the Hedge Fund Rule was not a reasonable interpretation of the Act.

The United States Circuit Court for the District of Columbia struck down the Hedge Fund Rule. Disagreeing with the SEC's interpretation of the word "client," the Court held that the Hedge Fund Rule was "arbitrary" and that the SEC departed from prior interpretations of the term "client" under the Act in extending the meaning of the term to include investors in hedge funds.

In August 2006, the SEC staff announced that it would not appeal the *Goldstein* decision, thus allowing advisers to hedge funds and private funds to remain unregistered. Instead, in July 2007, the SEC adopted Rule 206(4)-8, an antifraud provision under the Act, which enabled the SEC to bring enforcement actions against investment advisers to pooled investment vehicles, regardless of whether the adviser is registered under the Act.

Existing Regulations

The Act, in its current form, applies to investment advisers with over 15 clients who manage at least $25 million in assets. Advisers who manage less than $25 million are regulated by state law. The Act requires registered advisers to:

- maintain adequate books and records;
- establish comprehensive compliance programs; and
- establish and enforce a code of ethics

In addition, the Act requires disclosure of a broad array of information about an adviser's business, such as the amount of assets under management, fees, affiliations with other financial institutions, and any regulatory violations. Currently, although certain portions of these disclosures are publicly available, advisers are only required to provide full disclosure to their prospective and existing investors. If the proposed legislation is adopted, hedge fund advisers will be required to adhere to existing regulations as well as proposed amendments.

Proposed Legislation

The proposed amendments to the Act would require all investment advisers of a "private fund" with more than $30 million of assets under management to register with the SEC. The definition of a "private fund" would specifically include pools of capital that relied on the exemptions provided by Section 3(c)(1) and Section 3(c)(7) as noted above, thus removing the availability of the exemption. Of particular note, the amendment also asserts the SEC's authority to "ascribe different meanings to terms (including the term 'client') used in different sections" of the Act--clearly in reference to the *Goldstein* decision.

Once registered with the SEC, investment advisers to private funds will be subject to requirements such as:

- substantial regulatory reporting requirements with respect to the assets, leverage, and off-balance sheet exposure of their advised private funds;

- disclosure requirements to investors, creditors, and counterparties of their advised private funds;
- strong conflict-of-interest and anti-fraud prohibitions;
- robust SEC examination and enforcement authority and recordkeeping requirements; and
- requirements to establish a comprehensive compliance program.

Protection From Systemic Risk

The proposed amendments would allow the SEC to gather and share information on private funds with the Board of Governors of the Federal Reserve System (the "Board") and a proposed additional regulatory authority, the Financial Services Oversight Council (FSOC). The information would help determine whether systemic risk is building up among hedge funds and other private pools of capital. In the event that the Board and the FSOC determine that a fund poses a threat to the overall financial system, the Board and the proposed FSOC could then designate the fund as a "Tier 1 financial holding company," which is defined as a firm "whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness." Designation as a Tier 1 financial holding would subject the private fund to substantial regulatory oversight and heightened standards of risk management.

The amendments to the Act are one portion of the larger body of proposed legislation designed to restore confidence in the integrity of the U.S. financial system. The entire proposal is available on the website of the U.S. Treasury at www.ustreas.gov.