SEC Staff Issues Hedge Fund Report

On September 29, 2003, the staff of the Securities and Exchange Commission (the “SEC”) issued a 134-page report on hedge funds entitled Implications of the Growth of Hedge Funds. The report is the product of the staff’s investigation of the hedge fund industry that commenced in June 2002 at the direction of the SEC. The report is available on the SEC’s website at http://www.sec.gov/news/studies/hedgefunds0903.pdf. If implemented, the report’s recommendations should not significantly impact hedge funds’ trading strategies.

Registration of Hedge Fund Advisers as Investment Advisers under the Advisers Act

Many hedge fund advisers are not required to and do not register under the Advisers Act in reliance on the de minimis exemption under the Investment Advisers Act of 1940 (the “Advisers Act”), which excludes from registration investment advisers that have had fewer than 15 clients during the preceding 12 months and meet certain additional requirements. Under current rules, each hedge fund counts as one client; therefore, hedge fund advisers that manage 14 or fewer hedge funds are generally exempt from registration under the Advisers Act. They are, however, subject to the Advisers Act’s anti-fraud provisions.

The staff recommended amending Advisers Act Rule 203(b)(3)-1 to require hedge fund advisers to “look through” any hedge funds that they manage to count each investor in a hedge fund as a separate client of the investment adviser. Recognizing the limited resources available to the SEC for inspection and monitoring of registered investment advisers, the staff suggested that it might be appropriate to include a minimum assets under management size threshold which must be reached before hedge fund advisers are required to register. However, the staff did not explicitly suggest that the existing exemption for investment advisers that manage less than $25 million in assets be increased. In addition, the staff’s recommendation could alter the way in which a “client” is defined for other purposes under the Advisers Act, which could have a number of implications for hedge fund advisers.

The staff recommended that any adopted rule apply only to investment advisers of hedge funds and not to investment advisers of other types of unregistered investment vehicles, citing venture capital funds, private equity funds and structured finance vehicles as examples. It remains to be seen how different types of investment vehicles would be differentiated for this purpose. Requiring registration has the following primary implications:

- The minimum qualification standards applicable to individuals who invest in hedge funds relying on Section 3(c)(1) of the Investment Company Act of 1940 (the
If implemented, the staff’s recommendation that hedge fund advisers register with the SEC under the Advisers Act should not have a material impact on the way in which hedge funds invest. In the staff’s words, “[r]egistration would not place any restrictions on hedge fund advisers’ ability to trade securities, use leverage, sell securities short or enter into derivatives transactions…[,] would [not] require the disclosure of any proprietary trading strategy [and] would not result in…additional portfolio requirements.” Nonetheless, we expect that there will be additional costs and likely significant changes in such key areas as investor presentations, custody, record keeping (e.g., e-mail retention), trade entry and recordation, and valuation procedures.

Hedge Fund Brochure

The staff recommended that registered investment advisers of hedge funds be required to file with the SEC, and to deliver to investors, a periodically updated disclosure statement specifically designed for and made available to hedge fund investors. The recommended “hedge fund brochure” would contain disclosure about, among other things, various conflicts of interest, risk management measures the adviser performs, the manner in which the adviser values securities held by the hedge fund (and the extent to which that valuation will be determined independently), and lock-up periods that may apply to an investor’s investment in the hedge fund.

Registered Funds of Hedge Funds—Valuation, Suitability and Fee Disclosure Issues

The staff addressed the growing number of registered funds of hedge funds (“FOHFs”) with these recommendations:

- Requiring that all registered investment companies that invest their assets in hedge funds, including registered FOHFs, adopt procedures to ensure that funds and their boards value their interests in hedge funds in a manner consistent with the requirements of the Investment Company Act. This recommendation by the staff suggests that a valuation method registered funds traditionally employ when market prices for their securities are not readily available. The staff acknowledged that FOHFs often do not have access to information regarding the specific investments made by hedge funds in which they invest. However, the staff did not recommend that registered FOHFs be required to obtain such information or fundamentally alter their current approach to valuation of investments in hedge funds.

- The staff recommended that the SEC and the NASD continue to look for violations of broker-dealer suitability obligations. The staff, however, declined to make any specific recommendations with respect to broker-dealer determinations of suitability of hedge funds and FOHFs as well as their suitability for specific investors.
Adopting a previously proposed rule requiring all registered investment companies, including registered FOHFs, to disclose in their prospectus fee tables the estimated fees and expenses of the underlying funds in which they invest. According to the staff, such disclosure would assist investors of FOHFs in understanding more fully the multiple layers of fees incurred by both the fund in which an investor invests and the funds in which a FOHF invests. The staff did not address the fact that many FOHFs may not yet have selected the hedge funds in which they will be investing while they are in the process of initially offering their securities.

Permitting General Solicitation in Qualified Purchaser Offerings

The staff recommended eliminating the current prohibition on general solicitation and general advertising in connection with hedge fund and other fund offerings made to “qualified purchasers” in reliance on Section 3(c)(7) of the Investment Company Act. The staff theorized that lifting the current restriction would facilitate capital formation without raising significant investor protection concerns. This recommendation would pave the way for many hedge funds to market directly to prospective qualified purchasers through now-prohibited advertisements and other channels.

Other Recommendations

In addition to the above-listed recommendations, the staff recommended the following:

- Capital introduction services provided by prime brokers should be closely monitored by the SEC and the NASD.
- The hedge fund industry should be encouraged to embrace and further develop best practices.
- Investor education with respect to hedge funds needs to be improved.
- The wider use by registered investment companies of certain investment strategies employed by hedge funds should be studied.

Looking Ahead

The SEC commissioners have not yet considered the hedge fund report. Given the hedge fund industry’s significant impact on the Nation’s financial markets, the staff recommendations will likely receive a high priority from the SEC. In addition, there are a series of “big picture” issues which will need to be considered by the SEC as it determines whether to adopt the recommendations of the staff in the form of actual rule proposals. These issues include the allocation of SEC budgeting resources from a cost-benefit analysis, cross-regulatory agency and state coordination, Congressional interest and the specifics of a broader application of a comprehensive regulatory scheme. Sponsors of, and advisers to, hedge funds should not miss this meaningful opportunity to contribute their thoughts and suggestions to this process.
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For more information please contact any of the following attorneys in Fried Frank’s Corporate Department:

**New York**
- Lawrence N. Barshay
- Jessica Forbes
- Robert C. Schwenkel
- Richard A. Steinwurtzel
- Gil A. Raviv
- Rowena A. Villanueva

**Washington, DC**
- Richard A. Steinwurtzel

**Los Angeles**
- 350 South Grand Avenue
- Tel. 213.473.2000
- Fax 213.473.2222

**London**
- 99 City Road
- London EC1Y 1AX
- Tel. 44.20.7972.9600
- Fax 44.20.7496.9293

**Paris**
- 5, boulevard de la Tour Maubourg
- 75007 Paris
- Tel. 33.140.62.22.00
- Fax 33.140.62.22.29

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