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Hedge Fund Managers: Summary and Implications of New Rules Requiring SEC Registration*

On October 26, 2004, the Securities and Exchange Commission (the "Commission" or the "SEC") adopted a new rule and related amendments requiring, among other things, that hedge fund managers register with the SEC under the Investment Advisers Act of 1940, as amended (the "Advisers Act") by February 1, 2006.[1] In this article, we refer to the totality of the recent rulemaking as the "new rules." The new rules and a lengthy interpretive release (the "Adopting Release") were made available to the public on December 2, 2004.[2]

The new rules only slightly modify the text of the proposed rules published by the SEC on July 20, 2004.[3] We will refer to the July 20, 2004 rules as the "proposed rules." The proposed rules, which were opposed by two of the five SEC commissioners at the time they were announced, provoked a loud outcry and strong opposition. According to the Adopting Release, the SEC received 161 comment letters from investors, hedge fund managers, mutual fund managers, law firms, and others. Of these, only 36 supported the proposed rules, 83 argued against them, and the remainder presented a neutral view. The objections included "concerns about the costs of compliance under the new rule[s], …questions about [SEC] effectiveness in preventing hedge fund fraud, and the potential intrusiveness of [SEC] oversight of hedge fund managers."[4]

Nevertheless, in view of its principal responsibility to enforce and administer the federal securities laws for the protection of investors, the SEC felt compelled to act and adopt final rules substantially as proposed. The Commission concluded that its current regulation of hedge fund managers was inadequate and that registration would provide significant benefits, including access to information that is current, reliable, and complete and in a format susceptible to analysis by SEC staff as well as the deterrence of fraud.

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[1] Release No. IA-2333. <http://www.sec.gov/rules/final/ia-2333.htm>

[2] Id.

[3] Release No. IA-2266. <http://www.sec.gov/rules/proposed/ia-2266.htm>

[4] Adopting Release at p. 17.

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Overview and Effective Dates

The principal effect of the new rules is that many more hedge fund managers (both U.S.-based and offshore) will be required to register with the SEC, and as a result, will be subject to SEC regulation and oversight. Under the Advisers Act, an "investment adviser," which includes "any person who, for compensation, engages in the business of advising others…as to the advisability of investing in, purchasing, or selling securities," is required to register with the SEC unless an exemption is available.[5] In general, hedge fund managers satisfy the definition of an investment adviser, so in order to avoid registration, they must rely on an exemption.

Historically, most hedge fund managers have relied on the exemption under Section 203(b)(3) of the Advisers Act, known as the private adviser exemption. The critical part of this exemption is whether an investment adviser had fewer than 15 clients during the preceding 12 months. We refer to this as the "15-client threshold." The ability of a hedge fund manager to qualify for the 15-client threshold hinges on the definition of "client" as used in the exemption.

Before the adoption of the new rules, a hedge fund manager providing investment management to one or more funds had been permitted to treat a limited partnership or limited liability company as one client for purposes of the private adviser exemption so long as the advice provided to such entity was based on the investment objectives of the entity rather than the objectives of the various limited partners or members. This meant that a hedge fund manager could aggregate clients into investing entities and count numerous individual investors as one client. Under the new rules, hedge fund managers are required to count each investor in a fund or funds that it advises as its client rather than only counting the entity itself, assuming the fund meets certain criteria described below. Since most hedge funds have more than 14 ultimate investors, the practical result of this rule is that most hedge fund managers now will be required to register with the SEC.

The new rules, however, do provide a grace period for hedge fund managers not currently required to register with the SEC. These managers must be registered and otherwise in compliance with all SEC rules applicable to registered advisers by February 1, 2006. For hedge fund managers required to register under the old rules, there are two sets of effective dates. The effective date of the revisions to the rule relating to custody of client funds and securities[6] and Form ADV is January 10, 2005, and the effective date of the amendments to the rules relating to recordkeeping requirements[7] and performance fees[8] and the definition of client

[5] Advisers Act, Section 202(a)(ii).

[6] Rule 206(4)-2 under the Advisers Act.

[7] Rule 204-2 under the Advisers Act.

[8] Rule 205-3 under the Advisers Act.

for purposes of national *de minimis* standards[9] is February 10, 2005. These amendments are described below.

REVIEW OF NEW RULES

As discussed above, an investment adviser must register with the SEC if it does not qualify for an exemption.[10] Section 203(b)(3) of the Advisers Act, which codifies the private adviser exemption, provides that an investment adviser is not required to register with the SEC if it (i) has had fewer than 15 clients during the preceding 12 months, (ii) does not hold itself out generally to the public as an investment adviser, and (iii) is not an adviser to a registered investment company. Since most hedge funds can meet the requirements of (ii) and (iii), the requirement set forth in clause (i) above is the crux of the test.

Hedge funds usually have more than 14 investors; so if there is a "look-through," most hedge fund managers will not qualify for an exemption. The new rules amend the definition of the term "client" as used in clause (i) above to provide that if the client is a "private fund," the adviser may not count the fund as a single client but must look through the fund and count each investor in the fund as a client.[11]

In this section, we will (1) define "private fund" and discuss its intricacies, (2) describe how to "look through" a private fund and count its investors for purposes of determining the applicable number of clients for the 15-client threshold, (3) review certain special provisions applicable to offshore funds and offshore fund managers, and (4) explain the assets-under-management requirement for SEC registration eligibility. Later in the article, we review related amendments to the Advisers Act and implications of the new rules.

1. DEFINITION OF "PRIVATE FUND"

The SEC has determined that greater regulatory oversight is required of hedge fund managers than of advisers to all private investment vehicles. Consequently, the SEC has defined a "private fund," which a manager must look through for purposes of counting its clients, in a manner that distinguishes hedge funds from private equity funds and venture capital funds. Under Rule 203(b)(3)-1, a "private fund" is defined as a company:

[9] Rule 222-2 under the Advisers Act.

[10] An investment adviser must have assets under management of at least $25 million in order to be eligible to register with the SEC. Those advisers with assets falling below this threshold must look to the laws of the state in which it has its principal place of business or in which it does business to determine whether registration is required.

[11] A hedge fund manager located outside the United States must count only those investors in its fund or funds that are U.S. residents towards the 15-client threshold.

- that would be an investment company required to register under the Investment Company Act of 1940, as amended (the "Investment Company Act") but for the exceptions under Section 3(c)(1) exempting issuers with fewer than 100 investors or Section 3(c)(7) exempting issuers whose owners are all "qualified purchasers;"[12]
- that permits its owners to redeem any portion of their ownership interests within two years of purchase (see description of lock-up below); and
- the interests in which are offered based on the investment advisory skills, ability or expertise of the investment adviser.[13]

Since most hedge funds and, in fact, most private investment vehicles, including private equity funds and venture capital funds, will satisfy the first and the third characteristics described above, it is likely that managers will focus most closely on the two year lock-up.

Two-Year Lock-up

A fund will not fall within the definition of a "private fund," and its manager will be permitted to continue to count it as only one client for purposes of Section 203(b)(3), if it does not permit investors to redeem their ownership interests within two years of purchasing their interests, subject to the following:

- the lock-up period must apply to both a client's initial investment as well as each additional investment, provided that for funds in existence before the compliance date of February 1, 2006, the lock-up need only apply to investments made by new investors in a fund or additional capital contributions by existing investors in such fund after February 1, 2006[14];
- the lock-up may permit redemption in less than two years in the event of "extraordinary" circumstances, such as tax or regulatory reasons, the investor's death or disability, or a key-man event in which key personnel of the fund management company die, become disabled, or cease to be involved in managing the fund, and includes

[12] Section 2(a)(51) of the Investment Company Act defines "qualified purchaser" to include, among others, any individual that owns not less than $5 million in investments, and any person acting on its own account or the account of others that owns and invests on a discretionary basis not less than $25 million in investments.

[13] Hedge fund managers would not be able to fall outside of this characteristic by delegating investment management of a fund to a subadvisor. Adopting Release at note 243.

[14] Adopting Release at p. 27.

extraordinary circumstances that are agreed to in the fund's governing documents; [15]and

- the lock-up may permit redemption in less than two years of interests acquired through reinvestment of distributed capital gains or income.[16]

Following publication of the proposed rules, many commenters raised concerns about the application of the lock-up rules. In the Adopting Release, the SEC provided guidance to address many of these concerns. The SEC has clarified that:

- funds can use a "first in, first out" approach for determining the age of purchases and capital contributions[17];

- funds that permit certain investors to redeem interests in less than two years through the use of side letters, rather than in their governing documents, would fall within the definition of a "private fund;"[18]

- funds that have mandatory distributions payable to all owners in accordance with their governing documents, as distinguished from redemptions initiated by the investors, would not be deemed to be "private funds;"[19] and

- transfers by investors of their interests in funds in the secondary market within two years of purchase do not constitute redemptions that would cause a fund to fall within the definition of a "private fund."[20]

2. U.S. Based Managers - Counting Owners of a Private fund

If a fund qualifies as a private fund, under Rule 203(b)(3)-2 a U.S. based fund manager must look through the fund and count the fund's investors as the manager's clients in order to determine if the manager meets or exceeds the 15-client threshold. Shareholders, limited partners, members, and beneficiaries must be counted, and if any of such investors is itself a "private fund," it also must be looked through. With respect to a U.S. based manager, the look-through requirement applies equally to the U.S. and non-U.S. funds that it advises, and

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[15] Advisers Act Rule 203(b)(3)-1(d)(2)(i).

[16] Advisers Act Rule 203(b)(3)-1(d)(2)(ii).

[17] Adopting Release at note 231.

[18] Adopting Release at note 233.

[19] Adopting Release at note 241.

[20] Adopting Release at note 241.

the manager must count all investors in such funds, including both U.S. and non-U.S. investors. Different rules apply to offshore fund managers as described below.

Although ordinarily the number of an adviser's clients is counted by looking back 12 months and adding all current and former clients during that period, the SEC has granted an accommodation to hedge fund managers in determining whether they need to register under the new rules. The Adopting Release states that the look-through requirement for private funds will be applied only prospectively, and therefore a hedge fund manager need only count the number of investors in the fund as of the compliance date of February 1, 2006 and thereafter.[21] Of course, if the hedge fund manager has any separately managed accounts, these clients must be aggregated with its "private fund" investors for purposes of determining whether the manager meets or exceeds the 15-client threshold.

Exclusion of the Hedge Fund Manager and Knowledgeable Advisory Personnel

One of the few modifications that the SEC made to the proposed rules was the exclusion from the calculation of clients of the following "insiders" if they are investors in the fund entity: (i) the hedge fund manager itself, and (ii) certain knowledgeable advisory personnel that constitute "qualified clients" as defined in Rule 205-3(d)(1)(iii) under the Advisers Act and may be charged a performance fee. These "insiders" include:

- executive officers, directors, trustees, general partners or persons serving in similar capacities of the fund manager, and

- any employee of the fund manager (other than an employee performing solely clerical, secretarial, or administrative functions with regard to such manager) who, in connection with his or her regular functions or duties, participates in the investment activities of the hedge fund manager, provided that such employee has been performing such functions and duties for or on behalf of the hedge fund manager, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.[22]

The SEC makes clear in the Adopting Release that a hedge fund manager may not circumvent the rules and avoid counting an investor in a private fund towards the 15-client threshold by admitting such investor as an owner of the fund management firm.[23] In addition, the SEC has clarified that a hedge fund manager may, but is not required to, exclude the value of the interests in the private fund held by the insiders described above when calculating the firm's

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[21] Adopting Release at note 273.

[22] Advisers Act Rule 203(b)(3)-2(a).

[23] Adopting Release at note 194.

assets under management for purposes of the $25 million registration threshold (which is discussed in more detail below).[24]

Fund of Funds

Many investors in private funds are themselves funds. We will refer to those investors as "top-tier funds." Under Rule 203(b)(3)-2, a hedge fund manager must look through each top-tier fund and count its investors as clients for purposes of the 15-client threshold. In addition, under Rule 203(b)(3)-2, if any of the investors in a private fund is a registered investment company under the Investment Company Act, the hedge fund manager must look through the registered fund and count its investors as clients. These provisions are intended to prevent a hedge fund manager from providing its services to a very large number of investors through 14 or fewer "funds of funds."

A hedge fund manager is required to obtain sufficient information from its investors, including top-tier funds, on a periodic basis to determine its own registration obligations, but is not required to collect information as to the identity of the investors in a top-tier fund. Commenters had expressed concerns that the rules would create uncertainty as to the registration obligations of advisers to funds with investors that are funds of funds. In the Adopting Release, the SEC suggested that these concerns were unfounded because substantially all top-tier funds have more than 14 investors, and thus hedge fund managers with fund-of-funds investors would not be able to avail themselves of the exemption from registration in any event.[25]

3. Offshore Hedge Fund Managers

The SEC has adopted a number of special provisions to apply to offshore hedge fund managers that are intended to balance the interests of protecting U.S. investors and creating a level playing field for all market participants with the desire not to conflict with regulations in the home jurisdictions or cause the extraterritorial application of the Advisers Act.

Counting Clients

Offshore hedge fund managers with their principal office and place of business located outside the U.S. (we refer to such advisers as "offshore managers"), but who manage funds with U.S. investors, are subject to the same look-through provisions and counting requirements as U.S. managers. However, under Rule 203(b)(3)-1(b)(5), the offshore manager is required to count as clients only those investors that are U.S. residents. This special rule applies whether or not the fund advised by such offshore manager is organized offshore or in the United States.

[24] Adopting Release at p. 21.

[25] Adopting Release at note 196.

In the Adopting Release, the SEC set out its current guidance on whether an investor is a U.S. resident, but indicated that it may reconsider this question. For purposes of determining U.S. residency, a manager may look to: (i) in the case of individuals, their residence, (ii) in the case of corporations and other business entities, their principal office and place of business, (iii) in the case of personal trusts and estates, the rules set out in Regulation S under the Securities Act of 1933, as amended, and (iv) in the case of discretionary or non-discretionary accounts managed by another investment adviser, the location of the person for whose benefit the account is held.[26]

An offshore manager needs to make a U.S. residency determination only at the time of the investment in the fund. If the investor subsequently moves to the U.S., the investor retains its status as a non-U.S. investor.[27] However, if a non-U.S. investor transfers its interest to a U.S. investor, then the offshore manager must count the transferee as a client.[28]

Offshore Managers of Offshore Publicly Offered Funds

The new rules allow offshore managers of offshore publicly offered funds that meet the criteria specified below to avoid looking through such funds for purposes of determining whether they are required to register. The definition of private fund explicitly excludes a company that has its principal office and place of business outside the United States, makes a public offering of its securities in a country other than the U.S., and most importantly, is regulated as a public investment company under the laws of such country other than the U.S.[29] Although these offshore regulated investment funds often also raise capital in private placements with U.S. investors, the SEC has concluded (at least for now) that since these funds are subject to regulatory oversight in a foreign jurisdiction, there is adequate protection of U.S. investors.

Offshore Managers of Offshore Privately Offered Funds

Unlike offshore managers of U.S. funds, which are subject to the full panoply of the Advisers Act requirements with respect to the U.S. funds and their investors, offshore managers of offshore funds have more limited requirements. In order to minimize the extraterritorial application of the Advisers Act while still providing some protection for U.S. investors, the SEC has narrowed the application of the Advisers Act to offshore managers of offshore privately offered funds. These offshore managers are required to register with the SEC (unless they are eligible for the private adviser or other exemption), maintain certain books and records, and remain subject to SEC regulation. Although offshore managers must look

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[26] Adopting Release at note 201.

[27] Adopting Release at p. 22.

[28] Adopting Release at note 203.

[29] Advisers Act Rule 203(b)(3)-1(d)(3).

through and count the U.S. investors in the "private funds" they manage, they may treat each offshore fund, and not such fund's investors, as their client for purposes of otherwise complying with the Advisers Act. Many provisions of the Advisers Act, including compliance, custody, and proxy voting rules, performance fee restrictions, and brochure delivery requirements, do not apply to offshore advisers only advising offshore fund clients.

4. Eligibility for SEC Registration — Assets Under Management

Some smaller funds elect to register with the SEC even when they are not required to do so. The new rules do not change the current Advisers Act requirements that in order to be eligible to register with the SEC, an investment adviser must have aggregate assets under management of $25 million or more.[30] Also unchanged is the requirement that an investment adviser that has at least $30 million in assets under management, and that does not qualify for the private adviser exemption, register with the SEC.

For purposes of calculating the $25 million threshold, an adviser must include the total value of all securities portfolios that it manages in its assets under management, which amount is not reduced by borrowings used to acquire any assets. A hedge fund manager may exclude its own and its "insiders'" proprietary assets invested in the fund and the value of assets attributable to non-U.S. investors.

Regulation, including registration, of investment advisers with less than $25 million in assets under management remains with the applicable state securities authorities. However, an adviser whose principal office and place of business is outside the United States must register with the SEC if it has 15 or more clients who are resident in the U.S. regardless of the amount of assets the adviser has under management.

The SEC has indicated that if the regulation and oversight of the more than 1,000 additional investment advisers that will be required to register under the new rules becomes too burdensome, it will consider raising the minimum assets under management a fund is required to have in order to be eligible to register with the SEC.[31] This would effectively shift the regulatory oversight of advisers of smaller funds to the state securities regulators.

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[30] There are several exceptions to the $25 million threshold requirement, including, among others, for (i) investment advisers that manage a registered investment company, (ii) investment advisers that would otherwise be required by the laws of 30 or more states to register as an investment adviser in each such state, and (iii) newly formed advisers that expect to be eligible for registration (i.e. to be managing $25 million or more in capital) within 120 days of registration.

[31] Adopting Release at p. 145-46.

Related Amendments

Once registered, hedge fund managers will be subject to the ongoing requirements of the Advisers Act. The SEC has adopted a number of amendments to these requirements to facilitate the transition to registered status for hedge fund managers and to adapt certain rules to the hedge fund context. In this section, we will discuss the amended rules relating to (1) performance fees, (2) recordkeeping, (3) custody, (4) Form ADV, and (5) state investment adviser requirements.

1. Performance Fees

The SEC has amended Rule 205-3 which provides that registered advisers may charge performance fees, i.e., fees based on a share of the capital gains or appreciation on a client's funds, only if the client meets the requirements of a "qualified client."[32] In the case of clients that are investment companies exempt from registration under Section 3(c)(1) of the Investment Company Act, the Advisers Act rules require that each investor in the fund satisfy the "qualified client" standard.[33] A qualified client includes: (i) a person who has a net worth of more than $1.5 million; (ii) a person with at least $750,000 of assets under management with the investment adviser immediately after the advisory agreement is executed, (iii) an executive officer, director, trustee, general partner, or person serving in a similar capacity of the investment adviser, or (iv) an employee of the investment adviser who participates in the investment activities of such investment adviser and has been performing such functions on behalf of the investment adviser or substantially similar functions or duties for, or on behalf of, another company, for the last 12 months.

The new rules include a "grandfather" provision, under which a newly registered hedge fund manager is permitted to continue to charge a performance fee (or incentive allocation) on existing capital and additional capital contributions by investors in the fund that are not "qualified clients" if they invested in the fund before February 10, 2005.

2. Recordkeeping

The SEC has amended Rule 204-2, which required registered advisers to retain certain records of, among other things, their performance or rate-of-return claims used in offering memoranda or other materials to solicit new and existing investors for a period of five years after the performance information was last used.

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[32] Under another exception, a registered adviser is permitted to charge performance fees to clients who are private investment companies exempt from registration under Section 3(c)(7) of the Investment Company Act.

[33] Advisers Act Rule 205-3(b).

Newly registered hedge fund managers will be permitted to use performance information for any funds or other accounts they manage relating to periods prior to the effective date of the new rules without maintaining records supporting such information for any period prior to February 10, 2005. This amendment is intended to avoid putting newly registered advisers at a competitive disadvantage to currently registered advisers in promoting their returns. There is also a new rule clarifying that the books and records of the hedge fund manager include the records of the private funds for which the adviser acts as general partner, managing member, or in a similar capacity.

3. Custody

The SEC has amended Rule 206(4)-2, which required registered advisers with custody of client assets (which most hedge fund managers are deemed to have) to deliver audited financial statements to clients within 120 days of the fund's fiscal year end.

The SEC extended this period from 120 days to 180 days after fiscal year end for managers of funds of hedge funds (investing at least 10% of their assets in other unrelated pooled investment vehicles), so that such managers will have time to collect the information they need from the underlying funds in order to prepare such audited financial statements.

4. Form ADV

Form ADV, the investment adviser registration form, requires basic information regarding the investment adviser's experience, ownership and affiliates, disciplinary history, as well as certain aspects of its business and possible conflicts of interest. Form ADV does not require much substantive disclosure of the adviser's investment activities in recognition of the adviser's need to keep proprietary investment strategies confidential.

The SEC amended Form ADV to require advisers to "private funds" to identify themselves as hedge fund managers, to identify each hedge fund they manage, and to provide specific information as to each such fund, including, among other things, the minimum investment requirements and the current value of the fund's assets.

5. State Investment Adviser Requirements

Investment advisers are subject to regulation under both federal and state securities laws. However, if an adviser is eligible and elects to register with the SEC, it is exempt from registration with any state securities regulatory authority.

Section 222(d) of the Advisers Act provides that a state may not require an adviser to register with its state securities authority unless the adviser has a place of business located within the state or has had, within the preceding 12-month period, at least six clients that are residents of that state. In response to commenters' concerns, the SEC amended Rule 222-2 of the Advisers Act to clarify that for purposes of the *de minimis* standards, clients are to be calculated without giving effect to the new look-through requirements.

IMPLICATIONS OF NEW RULES

Besides the obvious implications of the new rules, there has been much debate about unintended effects of the rules. In this section, we discuss three of those debated implications. We agree that the rules may (1) extend lock-up periods and (2) increase pension plan investment in hedge funds. We also predict that there will not be (3) a rush by U.S. hedge fund managers to relocate offshore.

1. EXTENDED LOCK-UP PERIODS

Since adoption of the new Advisers Act rules, many have speculated that hedge funds will impose longer lock-ups on their investors to avoid registration and becoming subject to SEC oversight. The SEC stated in the Adopting Release that it will monitor the use of lock-up periods, and if there is abuse by funds merely trying to avoid registration, the SEC will either extend the minimum lock-up period required to avoid registration or change the definition of a private fund to look not to the length of the lock-up but to the nature of the investment strategy or portfolio composition of the fund. The market reality is that the length of a fund's lock-up is a material term to an investor and, in general, funds without an established track record or a "star" manager will have trouble raising capital if they impose lock-up periods in excess of 12 months.[34]

The SEC has been clear that a significant reason for excluding from registration funds with lock-ups of two years or more was to avoid inadvertently requiring registration of private equity and venture capital funds, which in general require investors to have longer commitments of capital. In connection with the release of the proposed rules, the SEC mentioned that for purposes of crafting a definition of a "hedge fund" whose manager should be covered by the new rules, it had looked to the Department of Treasury's definition of a private investment company in its proposed rules for private funds that should be required to adopt anti-money laundering programs. That definition excluded from the anti-money laundering requirements funds with lock-ups of two years or more because, in part, it is believed that these funds are less attractive to money launderers who like to move money quickly through different accounts and institutions. The logic for excluding funds with longer lock-ups from the anti-money laundering requirements does not seem relevant in the context of investment adviser regulations.

[34] It has been reported that Carl Icahn is having trouble raising capital for a new hedge fund because of the terms, including a one-year lock-up and stiff redemption penalties for those desiring to withdraw after two or three years. See "Going Short," *Alternative Investment News* at p. 12 (January 24, 2005).

Commissioner Glassman has stated that one potential consequence of the longer lock-ups is that there will be less liquidity in the market for hedge fund investors, since they will not be able to get their money out of the fund for a longer period. This is contrary to one of the SEC's usual market objectives. The market may respond to this decrease in liquidity by developing a secondary market for hedge fund investments similar to the secondary market for venture and private equity fund interests. However, this will not provide a full solution to the liquidity problem because investors have to incur a cost to transfer the interest both in terms of transaction expenses and potentially as compensation to the buyer for early liquidity.

2. Increased Pension Plan Investment in Hedge Funds

In the dissent at the end of the Adopting Release, commissioners Glassman and Atkins speculate that the new SEC registration rules, which are expected to limit access to hedge funds by smaller investors, may in fact encourage "retailization" of such funds. In the SEC's review of the hedge fund industry over the past few years, one of its principal concerns has been the growing exposure of smaller investors, pensioners, and other market participants to these secretive investment vehicles. These smaller investors have been able to access the hedge fund market because of the easing of minimum investment requirements by funds, the development of "funds of funds" that offer hedge fund shares publicly to a broader range of investors, and most significantly, the allocation of capital to hedge funds by public and private pension plans as well as universities, endowments, foundations, and other charitable organizations.

In the Adopting Release, the majority of commissioners contend that the mandatory registration requirements will limit retailization by imposing minimum standards for hedge fund investors. Since performance fees are an essential component of the economics of most hedge funds, and registered advisers may charge performance fees only to investors that meet the "qualified client" requirements described above, registration will have the effect of setting minimum standards for all hedge fund investors. The majority does recognize, however, that since the beneficiaries of pension plans are indirect investors in hedge funds through intermediaries that easily meet the minimum standards, these standards will not protect them.

The dissenting commissioners argue that pension funds and other institutional investors are likely to invest more money in hedge funds as a result of the SEC's rulemaking because they tend to limit their hedge fund investments to those with registered advisers. With more funds managed by registered advisers, there will be a greater menu of hedge fund investments for pension plans to choose from. In addition, Ms. Glassman and Mr. Atkins suggest that if all hedge fund managers are registered there is likely to be more broad based demand for access to hedge funds by retail investors.

The dissenters fail to mention one other significant reason that mandatory registration may increase the number and size of ERISA plan investments in hedge funds. Under ERISA rules, a hedge fund may not accept 25% or more of its assets from ERISA and other benefit plan investors without the fund's manager being appointed as an investment manager by the named fiduciary for each employee benefit plan subject to ERISA.[35] Such appointed investment manager must be a regulated financial entity, which includes a registered investment adviser under the Advisers Act. Since many hedge fund managers have rigorously avoided registration, to date they have opted to limit their investments from ERISA and other benefit plans to less than 25% of their assets under management. Now that such managers are required to register with the SEC, they may decide to comply with the additional ERISA requirements to be a plan fiduciary so that they can ramp up their marketing to, and accept an unlimited amount of funds from, benefit plan and ERISA investors. This may translate into a larger amount of ERISA money being invested with hedge funds and a greater number of retail investors having their assets at risk in such funds.

However, notwithstanding the likely increase in pension plan investments in hedge funds as a result of the new rules, there may be a basic flaw in the SEC's premise that these investments expose individual pensioners to hedge fund risks. By far, the growth in hedge fund investing by pension plans has been on the part of "defined benefit plans" rather than "defined contribution plans" (such as 401(k) plans).[36] A critical term of a defined benefit plan, that is different from the terms of a defined contribution plan, is that if there is an investment loss by the plan, the employer is required to put more money in the plan - the pensions paid to the retirees are unaffected. Thus, it is not the pensioners money that is at risk in hedge funds but rather the money of large corporations and state governments.

3. Hedge Fund Managers Moving Offshore

There has been much speculation that imposition of SEC registration on hedge fund managers would cause U.S. based managers to move offshore. It is feared that hedge fund managers will flee the United States to avoid the additional administrative burdens of registering and being registered, and to maintain their anonymity and that of their investors. In the proposing release, the dissenting SEC commissioners specifically queried whether "fears about more substantive regulation of hedge fund activity, business models, and business practices [would] drive hedge fund advisors offshore." These concerns have been echoed by Federal Reserve Board Chairman Alan Greenspan and Senator John Sununu (R-

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[35] There is one alternative to the 25% exemption that is often relied on by private equity and venture funds, but it is generally not available to hedge funds that invest primarily in publicly traded securities. This exemption is for funds that qualify as a "venture capital operating company." Generally, the regulations define a VCOC as an entity that invests at least one-half of its assets in companies in which the entity has management rights, which rights are exercised to some degree. Other exemptions exist, including an exemption for a "real estate operating company," but they would not be applicable to a hedge fund.

[36] See Adopting Release at note 38.

NH), as well as industry participants, such as the chief investment officer of the California Public Employees Retirement System, and members of academia and the media.[37]

Although offshore funds managed by offshore advisers are exempt from many of the substantive provisions of the Advisers Act, any offshore manager of a private offshore fund with 15 or more U.S. investors nevertheless will be subject to the same registration requirements as a U.S. manager of such an offshore fund as well as periodic SEC inspections and recordkeeping requirements. Therefore, although there is some benefit to a manager being based offshore, a mass exodus from the U.S. seems unlikely. Unless a manager were willing to forego or substantially limit the amount of capital from U.S. investors, the SEC still would have jurisdiction over an offshore fund manager, and there is a good possibility such manager also might be subject to oversight by foreign regulatory authorities. In addition, one must not underestimate the significant practical impediments to moving a fund management company offshore, including the relocation of key employees from the U.S.

Conclusion

In sum, under the new rules the majority of hedge fund managers most likely will have to become SEC registered investment advisers. There is speculation that some fund managers will take fairly significant steps to avoid registration including moving their operations outside the United States or structuring their funds with longer lock-ups to avoid the look-through provisions of the new rules. For those funds that are unable to take advantage of the above options or any other exemption from registration, there should be at least one unintended benefit of the new rules, which is the ability to accept a larger percent of their total capital from ERISA and other benefit plan investors.

Carolyn E. Taylor

If you would like to learn more about the Securities Practice Group at Covington & Burling, please call any of the following:

Washington	David Martin	202.662.5128
New York	Bruce Bennett	212.841.1060
San Francisco	Andi Vachss	415.591.7069
London	Edward Britton	+44.(0).20.7067.2119

[37] See, for example, K. Drawbaugh, "Greenspan questions SEC push to tame hedge funds," Reuters (July 20, 2004); J. Churchill, "SEC Overburdening Itself?," Primedia Insight (December 2, 2004); J. Anderson, "Hedge Funds March on D.C.," New York Post (July 16, 2004); and F. Partnoy, "Road Rules for Hedge Funds," The New York Times (December 15, 2004).