Preparing for the inevitable

Registration as an investment advisor: your clients will demand it; Congress may soon require it

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For many years, hedge fund managers wrestled with the question of whether they should register as investment advisors with the SEC. On the one hand, registration afforded a manager the status of legitimacy and credibility with clients. On the other, by not registering, a manager could avoid the expense and difficulty of the registration process, not to mention the watchful eyes of the regulators.

But soon the choice may no longer be available for most hedge fund managers as Congress prepares to take up new legislation designed to require all hedge funds – and by extension those managing them – to register with the SEC. There are currently two bills under consideration on Capitol Hill; one in the Senate and one in the House, which would require registration by most managers of hedge funds.

The Senate bill labeled the Hedge Fund Transparency Act of 2009, co-sponsored by Senators Carl Levin of Michigan and Chuck Grassley of Iowa, is designed to establish a new layer of registration for hedge funds, who previously operated under exemptions from registration contained in the Investment Company Act of 1940. As a result, managers of these newly registered hedge funds will be required to register as investment advisers under the Investment Advisers Act of 1940.

Currently the Investment Company Act contains certain exemptions from the definition of an "investment company", e.g. if the fund has fewer than 100 investors and does not make and does not propose to make a public offering of securities. Another favored exemption permits a fund to avoid registration if it limits investment in the fund to "qualified purchasers" as that term is defined under the Investment Company Act, and is not making and does not propose to make a public offering of securities.

The new law was long in coming and vigorously opposed by the industry for decades. With the sizable increase in and popularity of hedge funds over the last 15 to 20 years, regulators have long sought the ability to monitor and examine hedge fund activities in the United States.

The House version of this new legislation, dubbed the Hedge Fund Advisers Registration Act of 2009, takes a more straightforward approach to the problem. This bill seeks to eliminate the registration exemption for certain investment advisors with less than 15 clients under SEC Rule 203(b), discussed below.

Previous efforts at regulation focused solely on the investment managers who controlled and managed the funds, rather than the funds themselves. In 2003, the SEC commissioned a study by its staff to review hedge funds and their investment advisers. The decision to study the hedge fund industry was based, in large part, on the significant growth in hedge fund assets, coupled with the SEC's lack of information about these investment pools.

The 134-page report contained the central recommendation that managers of hedge funds be required to register as investment advisers under the Investment Advisers Act. Generally, fund managers were able to escape the registration requirement of the Advisers Act through their reliance on the exemption contained in Section 203(b) of the Act, commonly referred to as the "de minimis" exemption. This section exempts from registration fund managers that have less than 15 clients during the preceding 12 months, do not hold themselves out to the general public as investment advisors, and are ***not an investment advisor to a registered investment company*** [emphasis added].

Until that time the SEC's view was that each hedge fund was a separate legal entity and counted as one client, regardless of the number of underlying investors in the fund, and that a manager could manage up to 14 separate funds before triggering the registration requirements of the Advisers Act. The report recommended that the SEC "look through" the fund to the actual number of investors participating in the fund to determine the number of clients that the investment adviser was advising. In that scenario, virtually all hedge fund managers would be required to register as investment advisers.

In response to these recommendations as well as growing pressure resulting from the explosive growth of hedge fund assets, in 2006 the SEC promulgated new rules which required "looking through" the funds themselves and counting the individual investors in each fund as clients, as the report recommended. By changing the definition of the term "client," the SEC was able to close a loophole in the registration requirements for certain managers of hedge funds

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– or so they thought. Then came Phillip Goldstein.

Mr. Goldstein, an active hedge fund manager and outspoken critic of any attempts to regulate hedge fund activities, took on the SEC in a lawsuit and won. The case, Phillip Goldstein, et al. v. Securities and Exchange Commission, decided on 23 June 2006 by the United States Court of Appeals for the District of Columbia Circuit, essentially wiped away the SEC's changes to the definition of "client" and went further to rule that the SEC had exceeded its congressional authority in promulgating this new rule.

Once again it appeared as if the industry had dodged the registration bullet. But with the continued increase in hedge fund assets, coupled with the financial crisis and market meltdown in 2008, Congress was forced to take notice of this important issue.

The two new bills winding their way through the halls of Congress seek to remedy the registration dilemma both for the funds themselves as well as the persons who manage them. The proposed law creates a new level of registration for hedge funds with $50 million or more of assets under management under the Investment Company Act, requiring funds to register with the SEC. By so doing the law effectively vitiates the primary exemption from registration as an investment advisor under the Investment Advisers Act, upon which most hedge fund managers were relying. By managing a fund which is required to be registered under the Investment Company Act, hedge fund managers may no longer avail themselves of the exemption in Section 3(b)(3) of the Investment Advisers Act. Therefore, this new law will have the practical effect of requiring registration under the Investment Advisers Act of most hedge fund managers.

With the political tide of the country turning toward more stringent regulation and greater transparency of large financial institutions, it is unlikely that the hedge fund industry will be successful in persuading Congress to lighten or eliminate the registration burden that is certain to come. What is more likely is that hedge fund managers will have to be prepared for the new registration requirements soon to be foisted upon them.

To be ahead of the curve, fund managers should begin to organise themselves to prepare for registration as an investment advisor. To prepare your organisation for the inevitability of registering with the SEC as an investment advisor, we recommend the following steps:

What should unregistered advisors do now?

- **Organise your practice.** Be prepared to describe your business model, investment methodologies, ownership structure and participation criteria. You should prepare an organisation chart listing each member of the firm, their duties, areas of responsibility and qualifications, including qualifying examinations held by each person. Make sure you have a proper record keeping and filing system in place for each client and each investment programme that you offer. Review your customer agreements to ensure that all information, including disclosures and fee arrangements, are complete and accurate.
- **Study for and take the Investment Advisers Examination.** Everyone associated with an entity registered with the SEC as an investment advisor (with the exception of clerical personnel), must have the requisite advisory registrations. The qualifying examinations, which are administered by the Financial Industry Regulatory Authority ("FINRA"), are either the Uniform Investment Adviser Law Examination (Series 65) or the Uniform Investment Adviser-State Law Examination (Series 66), which combines the Series 65 and the Uniform Securities Agent State Law Exam (Series 63) which is required in some, but not all, states. The study materials for these examinations are available from independent vendors and not through FINRA or the SEC, many of which also offer review classes as well. It is strongly recommended that anyone seeking to pass these qualifying tests study the resource materials and attend a review course prior to taking the examination.

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- **Identify your chief compliance officer.** Current SEC rules require that a registered investment advisor appoint a qualified chief compliance officer ("CCO") who is responsible for the oversight, supervision and regulatory control of the firm's business. The CCO is also responsible for the organisation and integrity of the firm's books and records. The CCO should be someone with a strong background and experience in the industry to ensure compliance with all applicable SEC and state regulatory requirements. The CCO is also responsible for conducting an annual compliance review and risk assessment of the firm's compliance policies and procedures, the purpose of which is to test the adequacy of the firm's compliance procedures. He or she is also responsible for remedying any deficiencies which may be uncovered through the review process.
- **Conduct a test audit of your practice.** SEC examiners routinely exam new IA firms to check for compliance with applicable rules and record keeping requirements. A test audit of your practice can unveil weaknesses in your structure, systems or record keeping that could present a problem should the SEC examiners come knocking on your door. Conducting a test audit by an experienced compliance firm or attorney, will alert you to any systemic problems that may exist within your firm before the regulators catch it. Through this process, you can remedy problems and mistakes which, if found by regulators, can be costly and damaging to your firm's reputation and its good standing.
- **Consult with securities counsel experienced in advisory issues.** The most effective way to get and stay in compliance with all of the current and prospective regulatory requirements, is to work with experienced counsel knowledgeable in the current law and any future changes that may affect your regulatory responsibilities as an investment advisor. Rules governing the investment advisory arena are complex and ever changing. To remain compliant, a solid resource of quality and timely information is essential. Experienced counsel can help avoid the pitfalls of operating a successful and profitable business in a highly regulated environment. ■

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