

October 3, 2003

Memorandum

**SEC Staff Report on Hedge Funds**

**Introduction**

The staff of the SEC's Division of Investment Management released its report, *The Implications of the Growth of Hedge Funds* (the "Report"), to the SEC on September 29, 2003, following the Division's fact-finding study of the industry. The Report summarizes the Division's review of the operations and practices of hedge funds, which review began in June 2002 and culminated in the Hedge Fund Roundtable held in May 2003. A number of comment letters were submitted in conjunction with and in response to the Roundtable discussions. The Report recognizes the "beneficial role that hedge funds play in our financial markets" and makes a number of recommendations for the SEC's consideration. The full text of the Report may be found on the SEC's website at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

The most significant recommendation of the Report, if adopted by the SEC, would be to require many hedge fund advisers to register as investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act").

**Areas of Concern to the Staff**

The staff identified the following areas of concern:

- The SEC's lack of regulatory oversight of unregistered hedge fund advisers and the hedge funds they manage.
- The lack of information available to both the SEC and potential investors about hedge fund advisers and their hedge funds.
- The lack of independent checks on the valuation of hedge fund portfolio securities, especially in the case of registered funds of hedge funds.
- The "retailization" of hedge funds, i.e., the possibility that less sophisticated investors are now investing, or are able to invest, in hedge funds through pension plans, registered funds of hedge funds and other means.
- The disclosure provided by hedge funds and registered funds of hedge funds.
- Conflicts of interest that may arise as a result of the side-by-side management of an adviser's hedge funds and mutual funds or other client accounts, and as a result of hedge fund relationships with prime brokers (who may provide overhead, capital introductions, seed capital and other services to hedge funds).
- The general solicitation by hedge funds of investors through the media and the Internet (e.g., press articles, newsletters, institutional reporting services, public interviews and password-free websites).

**Recommendations**

Based on its concerns, the staff recommends that the SEC consider the following changes to the regulatory framework relating to hedge funds and their investment advisers:

**Requiring hedge fund advisers to register with the SEC as investment advisers, taking into account whether the benefits outweigh the burdens of registration.** Generally, investment advisers that have fewer than 15 "clients" and do not "hold themselves out to the public" as investment advisers are exempt from federal registration under the Advisers Act. Many hedge fund advisers are able to rely upon this exemption because an entity such as a limited partnership or a limited liability company (e.g., a hedge fund) is considered a single client, provided that the adviser gives advice on the basis of the investment objectives of the entity as a whole (rather than the objectives of any of the entity's individual owners). The staff's recommendation would likely result in the elimination of this exemption.

The Report cites the staff's belief that mandatory registration of hedge fund advisers would serve as a deterrent to fraud, encourage compliance and the adoption of compliance procedures, provide the SEC with important information about a significant participant in the U.S. financial markets, and effectively raise the standards for investment in hedge funds from the "accredited investor" standard to that of "qualified client." The staff notes that there may be additional costs to advisers, but suggests that those costs would not be burdensome. The staff also notes the limited resources available at the SEC to examine advisers. In an attempt to limit the number of new registrants and the strain on the SEC's resources, the staff recommends exempting the managers of venture capital funds, private equity funds and structured finance vehicles, and also suggests that the SEC consider its available resources in setting the threshold amount of assets under management required for registration. Currently, advisers with less than \$25 million under management are generally prohibited from SEC registration.

**Revising the regulations under the Advisers Act to require advisers to provide a brochure specifically designed for hedge funds.** The Report contains a recommendation that would require hedge fund advisers to provide a brochure including disclosure about various conflicts of interest, the adviser's risk management techniques, the method by which the adviser values securities in a hedge fund's portfolio and whether there is any independent verification of that valuation, and the lock-up periods to which the investor may be subject. The brochure would be filed with the SEC and the adviser would be required to update it periodically and provide it on an ongoing basis to the adviser's clients. The staff believes that the requirement that hedge fund advisers file a Form ADV and update it as needed would streamline the due diligence process for hedge fund investors.

**Requiring certain registered investment companies to follow board-adopted valuation procedures.** The staff recommends that the SEC consider adopting new rules to require the boards of directors of registered investment companies to adopt valuation procedures for the fund's portfolio holdings in hedge funds that are consistent with the requirements of the Investment Company Act of 1940, as amended, including the requirement that a board of directors use the standard of "fair value determined in good faith" to value any securities for which there are no readily available market prices.

**Requiring additional disclosure to be provided about layered fees of registered "funds of funds."** The staff recommends that the SEC adopt the proposed amendments to disclosure forms that were approved on September 24, 2003. These amendments would require all registered funds of funds, including all registered investment companies investing all or substantially all of their assets in hedge funds, to disclose the estimated fees and expenses of the underlying funds in the registered investment companies' fee tables. The staff believes that these amendments would provide investors with information they need to make a reasoned decision about their investment.

**Continue monitoring whether suitability obligations are being met.** The staff believes that the NASD's and SEC's focus in their broker-dealer examinations on whether broker-dealers are properly evaluating and disclosing the suitability of hedge fund investments in general and for their clients in particular has been an effective deterrent, and the staff encourages the NASD and SEC to continue to focus in this area.

**Permitting general solicitation in Section 3(c)(7) hedge fund offerings.** The staff suggests that the restrictions on general solicitation and the use of electronic media may not be necessary in the context of Section 3(c)(7) "qualified purchaser" funds. The staff believes that the "qualified purchasers" who are the target audience for 3(c)(7) funds, generally individuals with \$5 million in investments and entities with \$25 million in investments, do not need the protection that the prohibition on general solicitation

facilitates and believes that easing that prohibition would facilitate asset-raising and possibly provide more information to potential investors in those funds.

***Continue monitoring capital introduction services provided to hedge funds by prime brokers.*** At this time the staff is not making any recommendations to regulate these services, but is urging examiners to focus on capital introduction services provided to hedge funds by prime brokers.

***Encouraging the hedge fund industry to embrace and further develop "best practices."*** The staff notes that "best practices" procedures have been developed by a number of hedge fund industry groups and urges the groups to continue to refine those procedures and make them more specific. The staff encourages funds to adopt "best practices," suggesting that this could provide a "self-regulatory" solution to a number of issues.

***Continue focusing on investor education about hedge funds.*** The staff notes that the SEC's website currently provides a number of questions that an investor should ask before making an investment in a hedge fund or registered fund of hedge funds and encourages the SEC to continue to develop investor education in these areas.

***Issuing a concept release examining the wider use of hedge fund type and absolute-return investment strategies in registered investment companies.*** The staff suggests that hedge fund type and absolute-return investment strategies have been beneficial to, and protective of, hedge fund investors in the face of down markets and is interested in whether such strategies and protection should be made available to investors in mutual funds. The staff recommends that the SEC consider issuing a concept release addressing this issue. The staff also suggests that the SEC consider other ways to make such strategies available to a larger number of suitable investors. For example, the SEC might identify a way for a 3(c)(7) fund to accept investors who do not meet the "qualified purchaser" standard if the fund would provide other appropriate protections to the investors.

### **How the Recommendations would Affect the Hedge Fund Industry**

If the recommendations are adopted, a large number of currently unregistered hedge fund advisers would be required to register with the SEC, and they would be subject to SEC examination and audit. Registration would entail additional costs, including those of registration, electronic filing and setting up and maintaining Advisers Act-compliant systems. Moreover, the adoption of "best practices" and recent SEC rule proposals will necessitate the development of written procedures and policies which may not have been previously in place. There also would be additional disclosure required by the advisers on Form ADV and in the proposed hedge fund brochure. In addition, investors in hedge funds managed by registered investment advisers are required to meet the suitability requirements of the "qualified client" standard under the Advisers Act (a \$1.5 million net worth requirement that is slightly higher than the traditional "accredited investor" standard for individuals).

The recommendations do not include any changes in the status of hedge funds themselves as unregistered investment funds, should not impede the manner in which hedge funds invest or their strategies and should have no effect on hedge fund advisers' ability to utilize leverage, short sales or other typical hedge fund instruments. Hedge funds would continue to be exempt from registering their offerings, and no significant modifications generally would be needed in connection with their organizational structures, fee arrangements, or lock-up or redemption features.

SEC Chairman Donaldson has written that he anticipates receiving comments on the recommendations, and that the SEC will consider such comments in formulating any rules regarding oversight of the industry.

If you have any questions, please contact any of the attorneys in the Investment Management Group at Seward & Kissel at 212-574-1200.

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