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## Looking Ahead: What the Proposed SEC Regulations Mean to Hedge Fund Managers

In light of recent publicity surrounding the proposed regulations for registered and unregistered investment advisers — issued in response to the D.C. Circuit Court of Appeals decision in *Goldstein v. SEC*, which called into question the SEC’s ability to bring enforcement actions under the 1940 Advisers Act — DOAR spoke with an industry expert to obtain an insider’s view on the topic.

Ricardo W. Davidovich, a Partner at Tannenbaum Helpert Syracuse & Hirschtritt LLP in New York, specializes in the areas of hedge funds, investment management and futures and commodities. His focus is on structuring private investment companies in the U.S., as well as numerous off-shore jurisdictions. Ricardo advises U.S. and non-U.S. clients as to matters relating to the Investment Advisers Act of 1940, Investment Company Act of 1940, the Commodity Exchange Act, as well as SEC, NASD, NFA, CFTC and Blue Sky compliance issues. In addition, he is a frequent lecturer on investment advisory and hedge fund matters. DOAR recently had an opportunity to obtain his perspective on the proposed regulations.

### **How do you think current hedge fund managers will react if the proposed regulations are enacted?**

There are two different kinds of regulations in play — one is an anti-fraud regulation (proposed Advisers Act rule 206(4)-8), and the others are eligibility regulations (proposed Securities Act rules 509 and 216).

The anti-fraud rule will have some degree of impact. Section 206 of the Advisers Act, the anti-fraud section of the Act, has always applied to registered and unregistered investment advisers. The current issue is that the specific rules previously promulgated under section 206 only apply to registered investment advisers and, further, only with respect to their “clients.” The quirk remaining after the *Goldstein* court killed the hedge fund adviser registration rule is that the Court also indicated that for purposes of section 206, the word “client” applies to a hedge fund advised by an adviser, not the investors in such a fund. The SEC staff is now attempting to clarify that the SEC has the ability to bring enforcement actions against advisers with respect to their fraudulent actions against investors and potential investors in pooled investment vehicles.

How will hedge fund managers react if it is enacted? I don’t think that the concept is particularly overwhelming, but there are aspects in the proposal that create some concern. The language in the rule is fine, but the language in the release — which is critical in reflecting the drafters’ intent — is very broad. It mentions that the new anti-fraud rule would apply to things like the description of management’s biographies, the description of a fund’s strategy, the description of a fund’s risk factors and what is contained in investor account statements.

Certainly we would never expect a fund manager to be less than straightforward and honest when describing his background or the fund’s strategy or risk factors, but in light of the fact that the release specifically states that this anti-fraud rule does not require a showing of scienter — it does not require a showing that the adviser intended to violate the rule — something that would otherwise perhaps be an error or some sort of negligence becomes actionable under the new rule. Sometimes there is a difference of opinion over how much disclosure is sufficient in an offering document. If the SEC feels that disclosure is insufficient, they can bring (or threaten to bring) an anti-fraud claim under this new rule.

Fund advisers should react by considering all documentation they have out there; offering documents, marketing materials, client account statements, etc. They should review these documents to determine if additional disclosure is necessary or advisable and/or if more legends or disclaimers need to be added.

The second set of rules will have a more significant effect. They are rules that seek to raise the eligibility standards for natural person investors (meaning people as opposed to entities) in hedge funds pursuant to the definition of “accredited investor” under Regulation D and related rules. The original Regulation D standard was put in place in 1982 and has never been readjusted to take inflation into account. But to take a standard that for individual investors has historically been based on net assets or annual income and to now make it subject to an investment portfolio test is one issue that seems strange. This type of investment portfolio standard is currently used in the definition of qualified purchaser for purposes of a 3(c) (7) fund, but has not otherwise been used. The legislative history for 3(c) (7) makes clear that the test for 3(c) (7) was intentionally more restrictive than the accredited investor test for a 3(c) (1) fund.

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Under the proposed rules, a human being would have to meet the existing standards (a net worth test or an annual income test, each of which is unchanged by the proposed rule) and would also have to own at least \$2.5 million in investments, as defined in the proposed rules. The \$2.5 million seems excessive. Currently, a registered investment adviser may only charge a performance fee to clients or investors that are “qualified clients” – generally, investors that have a net worth in excess of \$1.5 million. Why is it that someone in a 3(c) (1) fund is sophisticated enough to be charged a performance fee at \$1.5 million, but is not sophisticated enough to invest in such fund unless they have at least \$2.5 million?

There are other aspects to the proposed eligibility rules that are peculiar. The rules specifically exclude every kind of investment vehicle or private placement other than a 3(c) (1) hedge fund. Why does the SEC think that an investment vehicle is automatically riskier than a private placement made by a group looking to start a biotech company, for example? Why does the SEC feel it is harder for someone to analyze the risks with respect to a hedge fund, or that a hedge fund is inherently riskier and more speculative, than an offering made by a group of people starting a company that requires you to place money and be locked up for five or 10 years and that will go into some technology

that no one understands — why should the eligibility standard be less for that? It doesn't seem reasonable.

How do I think fund managers will react if this one is passed? For starters, the new eligibility standard will be too high of a threshold for a percentage of the investing population. There will be some fund managers who simply will not be able to live with it in the sense that they have a difficult time raising money from accredited investors under the current definition. Even those that can raise the money are placed at an unfair disadvantage — the proposed rules do not create a level playing field. Specific kinds of venture capital funds are excluded from the applicability of the new rules; the proposed rules will allow venture capital funds and other kinds of funds that are not 3(c) (1) funds to raise money from investors that are not allowed to invest in a 3(c) (1) fund. So again, a venture capital fund that locks up an investor's money and makes investments in new ventures (I don't understand why that's not considered risky) is not subject to these proposed rules. As such, someone who has less money (because they do not meet the standards under the proposed rules) is allowed to invest in a private venture or venture capital fund, take the risk of not being able to withdraw their money for many, many years, and is conceivably exposed to the same if not greater risk of losing it all as someone who invests in a hedge fund. These proposed eligibility rules are great for venture capital funds; to the extent they are excluded from the rules, they can pick up a segment of the population that is looking to make investments and that may no longer be eligible to invest in 3(c) (1) funds.

In the proposed rules' release, the SEC points out that if the new eligibility rules are passed, fewer people will qualify as accredited investors. The SEC's Office of Economic Analysis conducted a study and determined that approximately 1.3% of U.S. households would qualify for the new standard of accredited natural person. They also estimated that in 1982, when Regulation D was first adopted, approximately 1.87% of U.S. households qualified for the original standard (they estimated that by 2003, the percentage of accredited investors had jumped to 8.47% from 1.87%; a 350% increase). So they are now proposing a rule that will include fewer people than were eligible for the initial rule when it was passed. What they are saying is that they want to push down the number of eligible investors from 8.47 percent, as of 2003, to 1.3 percent. This means that all of the 3(c) (1) fund managers will be pursuing a smaller pool of investors. The SEC says that such competition may result in lower fees. Why should that be a factor for the SEC? This is a free market business. Hedge funds are not a mandatory investment for a pension plan or anyone else. If someone thinks that a fund's fees are too high, there is a simple solution; don't invest in it. There are mutual funds, there are brokers and there are a lot of other options out there. It is possible that you will see some investors get the benefit of reduced fees, but you may also find some fund managers deciding to abandon their 3(c)(1) funds if they cannot raise sufficient assets in them.

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**Do you think that hedge fund managers or counsel will conduct their own internal investigations in an effort to prepare for potential regulations?**

Yes. If these rules are passed, a document review should be undertaken with respect to the anti-fraud rule to ensure there is nothing that is vague or insufficient.

The eligibility rules would absolutely require fund documents to be revised. The new standard for “accredited natural persons” needs to be built into offering documents. Fund managers need to understand that eligibility is a point of sale concept. If somebody was an accredited investor when they invested in a 3(c)(1) fund (due to their income or net worth) and their financial situation changes such that they are no longer accredited, the fund does not have to redeem them. The fact that they have stopped being accredited has no effect. The investor would be precluded, however, from making additional investments; he has to be an accredited investor every time he invests. Similarly, under the new eligibility rules (if they are passed), to the extent you are an investor in a fund today because you qualified as an accredited investor under the previous standard, you are allowed to maintain your investment. If you want to make an additional investment in the fund, however, you will need to meet the new standards. So, certainly all the fund documents will have to be revised to incorporate the new eligibility standards.

**How important is it for hedge funds to protect and manage electronically stored information (ESI), in light of the possible shift from being an unregulated to a regulated industry?**

Under Exchange Act rule 17A-4, broker dealers are required to maintain all communication received and sent relating to its business, including inter-office memos and communications, but, more importantly, including e-mails and instant messages. This rule does not apply to investment advisers and there is no such rule under the Advisers Act. Advisers Act rule 204-2, the record-keeping rule for registered investment advisers, sets forth categories of records that must be maintained. If a record or document (including e-mail) falls within one of the categories contained in rule 204-2, the record or document must be maintained; if it does not, there is no obligation to maintain it.

A few years ago, it became clear to regulators and advisers alike that e-mail and other electronic media may fall within the category of records to be maintained pursuant to rule 204-2. Conversely, just because you have an e-mail, it does not mean you have to keep it. The state of the law today — and the SEC, from what I understand, is in the process of looking at the electronic media issues relative to the Advisers Act with an eye towards rule making — is that if you are a registered investment adviser and you have a record, e-mail or otherwise, that fits within 204-2, it must be maintained.

This, in effect, forces a registered adviser to implement e-mail retention policies (even though there is currently no rule specifically requiring such a policy). When the SEC

comes in to conduct an examination of a registered investment adviser, they often ask for a copy of the adviser's e-mail retention policy. An answer of, "We don't have one, it's not required," will not be taken well. Their response will be, "There are books and records retention requirements, some of your e-mails likely fall within those requirements, so what are you doing to ensure that they are being maintained?"

The real tension comes in when you have e-mail or digital information that is outside the scope of rule 204-2; you keep e-mails that have nothing to do with anything that's required to be maintained. The SEC has said, at least orally, that their inspection right is not limited to what is expressly covered by rule 204-2. Their view is, if it is in the adviser's place of business when the examiner comes in, the examiner has the right to see it. The result is that an adviser has to give careful consideration as to what their e-mail retention policy should be. Should the policy be that they keep everything, in which case the adviser has to deal with things like how much it costs to store all the information? Should the adviser outsource the storage? Who has the right within the advisory firm to decide what to keep and what to delete? Should the adviser have a policy requiring the compliance officer to review the e-mails and decide what must be kept and what may be deleted? The adviser needs to understand that it is okay to keep things that are not required to be maintained, as long as the adviser is okay with having the SEC have access to it; if you keep everything, it is subject to the SEC's inspection right (at least in the SEC's view).

**Do you think hedge fund managers will adopt new practices in an effort to comply with potential regulations, or do you think they will wait to see which regulations are imposed before they act upon them?**

Take a step back and understand the way a regulator views this. A few years ago, the SEC made it clear that they were changing the way that they conduct examinations. When an examiner goes to an advisory firm, they are going to gauge the firm's culture of compliance. How robust they feel a firm's culture of compliance is will dictate how they conduct their examination. If they feel that the culture of compliance is not meaningful from the top down (they will meet with senior management in an effort to ascertain this), and that there is a lack of sufficient policies and procedures (or adherence to existing policies and procedures), the examination will be much deeper and you increase the likelihood of a more meaningful deficiency letter and enforcement actions.

Any time new rules like these come out, an adviser needs to adopt new policies or new procedures, particularly if it is a registered investment adviser. A registered adviser has to revise its documents to comply with the rules. If the adviser is unregistered, it may not have compliance manuals as such, but as a practical matter, the adviser should ensure that someone in the organization is charged with the responsibility of determining whether they are following best practices. This is particularly true with respect to these rule proposals as they apply to unregistered investment advisers as well as registered advisers

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**Do you feel it is important to establish a uniform defense when faced with a government or regulatory investigation? How would you recommend hedge funds prepare for this?**

Maybe the question is what do you do when a manager is faced with a governmental or regulatory investigation? An adviser should ensure that there is an immediate stop to the destruction of documentation, even if the adviser's policies allow the destruction of documentation.

You have to look at what the examination is focused on and what information has to be culled, and determine what outside specialists have to be brought in to assist with any kind of electronic document retrieval or archiving. The Advisers Act requires that anything maintained electronically be easily indexed and searchable; it is never an appropriate excuse for a manager to say that they cannot locate the documents in sufficient time.

The next step would be to determine the scope of what is being asked for and who is best to help do that. Can counsel help? Do you need the services of a third-party provider? You proceed from there.

For more information, or to learn more about the DOAR CLE, "Managing Your Data in Response to Regulatory Investigations," designed specifically to benefit counsel representing investment advisors, e-mail us at [info@doar.com](mailto:info@doar.com).