ROBERT G. HUTCHINS - LEGAL BULLETINS

December 2015 - Hedge Fund Growth Drives Increased Regulation of Investment Advisers

Introduction

The financial wizards who provide investment advice to large hedge funds occasionally become media figures replete with a colorful mystique. Though such celebrity is unusual, the reasons for it are not hard to discover. These advisers communicate with the financial community and their own clients using a jargon they alone completely understand. They analyze market movements using undisclosed algorithms they claim are proprietary. Their advisory contracts provide them with lavish compensation and unfettered discretion to bet client money on all manner of investments. Despite the high degree of associated risk, their funds are enthusiastically financed by affluent followers attracted by the advisers' star quality and the prospect of high returns. As a result, the advisers can maintain a public persona larger than life while amassing fortunes through a process most of us could not distinguish from alchemy.

Not surprisingly, advisers to the biggest funds fairly radiate confidence. They regard their demonization by the political left as a mark of their success. They have been known to refer to themselves, not entirely facetiously, as "Masters of the Universe." Until July of 2010, they could burnish their image while hiding their methods by operating so far below the SEC's radar that little was known publicly about their advisory contracts or the capital structures and operating results of their funds. This held true even for advisers who managed billions in financial assets for a thousand or more investors.

Inevitably, however, the rise of inscrutable hedge funds that were controlling enormous accumulations of capital prompted increased regulation of all investment advisers. This Bulletin reviews the legal underpinnings of the hedge fund phenomenon and summarizes the evolving regulatory regime.

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"Private" Investment Advisers and their Hedge Funds

An "investment adviser" is "any person who, for compensation, engages in the business of advising others …directly or through … writings…as to the value of securities or …the advisability of investing in, purchasing or selling securities…" A "hedge fund" is a pooled investment vehicle that pays performance fees to its advisers, engages in transactions forbidden to mutual funds (e.g. short sales) and is often highly leveraged. Hedge funds invest in securities. Persons who earn their livelihood by evaluating or recommending those securities are "investment advisers." If not exempt, investment advisers must register with the SEC or one or more states and satisfy an array of qualification standards, reporting and disclosure obligations and conduct rules.[1]

Prior to July 21, 2010, a major exemption from federal registration was available for so-called "private advisers;" those who, during the preceding 12 months, had fewer than 15 "clients" and neither held themselves out to the public as an investment adviser nor provided advice to a registered investment company or a business development company. The utility of this exemption was greatly enhanced by an Investment Advisers Act Rule that treated a "legal organization" as a single "client," regardless of the number of its owners, if the adviser's services were furnished only to the organization as a discrete entity and not to the owners individually.[2]

Large hedge fund advisers are invariably industry veterans with extensive networks of wealthy investors. For years, such advisers and their funds remained free of federal oversight by combining the exemption from registration for "private advisers" with exemptions from securities registration for "non-public" offerings and from registration as an investment company for pooled investment vehicles that do not offer their securities publicly and either have no more than 100 beneficial owners or are owned exclusively by "qualified purchasers" (e.g., natural persons with at least $5 million in investments and companies investing at least $25 million).[3]

To claim these exemptions, the advisers would cheerfully refrain from promoting their services through media advertising or other forms of general solicitation, thus satisfying the prohibition against "holding themselves out" to the public. Nor would they provide services to registered investment or business development companies. Instead, they would form up to 14 "legal organizations" (e.g., limited liability companies) and sell ownership interests in them to "accredited" investors in their existing networks. To avoid the risk that their investors would prove not to be "qualified purchasers," the organizations usually had a maximum of 99 owners.

The organizations were called "funds" and the funds became the designated "clients" of the advisers. The advisers caused each fund to raise investment capital by selling its ownership interests in "non-public" offerings. No advertising or other "general" solicitation was used (or necessary) to promote these sales. Accordingly, while the ownership interests were securities, the transactions in which they were offered and sold were exempt from Securities Act registration. In addition, because they had neither offered nor proposed to offer securities to the public, and either had fewer than 100 beneficial owners or were owned

[1] The "investment adviser" definition appears in Section 202(a)(11) of the Investment Advisers Act of 1940. The federal registration requirement is imposed by Section 203(a) of that statute. Neither the nuances of the definition nor the regulation by states of investment advisers, investment companies and securities transactions is addressed in this Bulletin. For information on those subjects, see www.hutchins-law.com - "Publications."

[2] The private adviser exemption was found at Section 203(b)(3) of the Investment Advisers Act. The supporting definition of the term "client" appeared in Rule 203(b)(3)-1(a)(2) under the Act. As noted below, the Advisers Act was amended to eliminate the "private adviser" exemption and the supporting Rule has been withdrawn.

[3] The non-public offering exemption is provided by Securities Act Section 4(a)(2). Rule 506(b) under the Act provides a safe harbor for the exemption. The pooled investment vehicles were exempt under Sections 3(c)(1) and 3c)(7) of the Investment Company Act. "Qualified purchasers" are defined in Section 2(51)(A) of the latter statute.

entirely by "qualified purchasers," the funds were exempt from registration under the Investment Company Act. The fact that the funds were formed specifically to invest in securities was irrelevant.

Thus, by their adroit use of common statutory exemptions, well-connected hedge fund advisers could, without federal registration of any kind, provide advisory services for the benefit of as many as 1,386 investors whose ownership interests were divided among 14 separate "clients," each consisting of a "fund" with no more than 99 owners. For that matter, the same 14 funds could have an unlimited number of owners if all of them were "qualified purchasers."[4]

Then, in the late 1990s, hedge funds emerged from the shadows and began to grow exponentially in size and number while steadily broadening their investment portfolios. By mid-2008, some reports had unregistered hedge fund advisers managing a total of US $2 trillion in assets. Hedge funds suffered substantial reversals during the ensuing credit crisis as a result of trading losses and investor withdrawals, but by at least one estimate will recover fully as the US economy finally sheds its post-recession doldrums and begins to grow at a sustainable rate.[5]

The SEC's Response to the Hedge Fund Phenomenon

The growing influence of secretive hedge fund advisers, who were not burdened by the investment restrictions and governance limitations imposed on regulated investment vehicles such as mutual funds, finally drew the attention first of the SEC, then of Congress. In December 2004, the SEC responded with a unilateral effort to regulate the advisers through its infamous "Hedge Fund Rule." This broad-axe summarily put an end to the Rule that treated a "legal organization" as a single client by decreeing that all owners of any "private fund" to which an investment adviser provided services (e.g., a hedge fund) were "clients" of that adviser.[6]

The Hedge Fund Rule was promptly and successfully challenged. On June 23, 2006, the SEC's order implementing the Rule was vacated by the Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC*.[7] To the *Goldstein* Court, the Rule patently exceeded the SEC's authority because it wrongly and unreasonably assumed that anyone who purchased an ownership interest in a fund automatically had a "client" relationship with the fund's adviser, i.e., was a person with whom the adviser had contracted to provide services and to whom the adviser owed a fiduciary duty.

In fact, the Court observed, the fund is a distinct and independent legal entity. The adviser is engaged by the fund to enhance its own financial performance; not by the owners to serve their diverse and often conflicting financial objectives. Consequently, the adviser owes its fiduciary obligation solely to the fund. It would face an irreconcilable conflict of interest if it tried to fulfill that obligation while

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[4] Compliance with Securities Act Rule 506(b) ensures a safe harbor for the Section 4(a)(2) exemption for "private," offerings made without general solicitation. The funds with only 99 owners were exempt under Section 3(c)(1) of the Investment Company Act; those owned solely by "qualified purchasers" by Section 3(c)(7).

[5] See, e.g., Staff Report to the SEC, *"Implications of the Growth of Hedge Funds,"* September 29, 2003; Managed Funds Association, *"Comments on SEC Regulatory Initiatives under the Dodd-Frank Act,"* September 22, 2010; and Hawthorne, *Hedge Fund Investors Expect Industry Growth,"* HFM Week, March 3, 2011. "Hedging" involves offsetting potential losses on favored securities by purchasing others with a "negative correlation" to them (an opposed price movement). As hedge funds diversified, "hedging" ceased to be a defining strategy of their advisers.

[6] Unlike hedge funds, mutual funds may not trade on margin or engage in short sales, must have independent directors and may not issue debt or invest in commodities or real estate without owner approval. The "Hedge Fund Rule," 203(b)(3)-2(a), defined a "private fund" as one that (i) would be required to register as an investment company "but for" Sections 3(c)(1) or 3(c)(7) of the Investment Company Act, (ii) permitted owner redemptions within two years and (iii) was promoted by touting its adviser. The two-year redemption period excluded private equity funds that invest in whole companies and do not have inordinate influence on capital markets. See also, www.hutchins-law.com "Essays/January 2005:" *"Hedge Fund Redux - Registration Required for Fund Advisers."*

[7] 451 F. 3d 873 (2006)

simultaneously observing a like obligation to the owners. If the fund were threatened with insolvency, for example, the adviser would be obliged to help the fund retain investment capital, but its advice to the owners would necessarily be to withdraw their capital or sell out. The "Hedge Fund Rule" thus disregarded both the realities of the marketplace and the legal relationship between the adviser, the fund and the fund's owners.

Nor was the Rule justified on policy grounds. It tolerated an exemption from registration under the Investment Company Act for *funds* with 99 owners while requiring *advisers* to funds with only 15 owners to register under the Investment Advisers Act, a companion statute.

As matters transpired, though, the judicial reprieve granted to "private advisers" proved to be short-lived. First, while the SEC did not appeal the *Goldstein* decision, it reacted by adopting Advisers Act Rule 206(4)-8 effective September 10, 2007. This Rule makes it unlawful for an adviser to misstate or omit a material fact in a communication to investors or prospective investors in a "pooled investment vehicle," or otherwise to engage in conduct that has the effect of defrauding such investors. The Rule thus subjects an adviser to liability for material misrepresentations it makes to owners without regard to whether the owners are "clients."

Second, the demise of the Hedge Fund Rule was followed quickly by the "Great Recession" of 2007 to 2009. Congress immediately looked for suitable scapegoats to divert attention from its own role in that debacle and Wall Street was a convenient target. Congress singled out hedge fund advisers by accusing them of irresponsible practices that allegedly were primary contributors to the stock market decline and the collapse of the housing market. It seems the advisers routinely caused their funds to engage in short sales and to invest in subprime, adjustable rate mortgages. While no one suggested this was illegal per se, Congress insisted that the short selling exacerbated the stock market decline while the mortgage purchases sustained a secondary market for unconscionable loans to unsophisticated, defaulting borrowers that proved devastating to the housing market and the economy as a whole. To add insult to injury, the advisers compounded these transgressions by remaining unregistered and closed to federal scrutiny.[8]

Enter Congress - The Dodd Frank Wall Street Reform and Consumer Protection Act

The antipathy of Congress ensured that the advisers freewheeling days were over. On July 21, 2010, the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") became law. Dodd Frank has been hailed by the left as a visionary overhaul of the legal regime for financial markets and vilified by the right as an overreaching legislative morass reflecting the worst excesses of big government. It is at least clear that, for good or ill, the "Reform" introduced by this statute was comprehensive and accompanied by a vast expansion of federal power. Among other things, Dodd Frank:

- created a "Financial Stability Oversight Council," or "FSOC," to identify and mitigate "systemic" risks to US financial stability and to recommend policy changes to the primary regulatory agencies for US financial institutions (the SEC, the Federal Reserve, the FDIC and the Controller of the Currency). The recommendations may involve such things as investment concentration limits, methods for closing regulatory "gaps," requirements for the management by financial institutions of their credit exposure and implementation of Federal Reserve supervision over *nonbank* financial companies whose insolvency *may* pose risks to US financial stability.[9]

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[8] For a summary of the financial crisis blame game see, e.g. Kaal, *"Financial Market Regulation after the Crisis: The Case for Hedge Fund Regulation via Basel II;" 2010;* http://works.bepress.com/wulf-kaal/1.

[9] "Systemic" risk is said to arise from the insolvency of two types of financial institutions; the first is extraordinarily large for its market ("too big to fail"); the second has a mutually dependent functional relationship with other market participants ("too interconnected to fail"). The insolvency of the first deprives its market of an ultimate source of capital and infrastructure. The insolvency of the second triggers a domino-like sequential crippling of institutions that together comprise the backbone of their market. Either result can collapse an entire financial system. The

● created within the Treasury Department an Office of Financial Research to support the FSOC and an Office of National Insurance. The latter Office will "advise" the Secretary of the Treasury on insurance policy issues and "monitor" the availability of affordable insurance to low income and minority persons. The Office has the authority to "collect" data "from" the insurance industry and individual insurers, identify regulatory gaps that could create systemic risk in the US insurance industry and recommend to the FSOC that a particular insurer be subjected to supervision by the Federal Reserve;

● created within the SEC an Office of Credit Rating Agencies to examine entities registered with the SEC as "nationally recognized statistical rating organizations" and verify their compliance with statutory and SEC requirements;

● created a federal Consumer Financial Protection Bureau to provide guidance to commercial lenders, mortgage lenders and credit card companies respecting consumer protection regulations and evaluate their compliance with them; and

● in Title IV, provided for the "Regulation of Advisers to Hedge Funds and Others."

Title IV and its implementing SEC Rules brought about significant changes in the registration, reporting and exemption requirements for investment advisers in general and hedge fund advisers in particular.[10]

Elimination of the "Private Adviser" Exemption from Registration

Dodd Frank reaches hedge fund advisers by amending the Advisers Act to require registration by any US adviser who has more than $150 million in assets under management ("AUM") and acts for a "private fund," a term salvaged from the defunct "Hedge Fund Rule." A "private fund" is an issuer that would be required to register as an investment company but for the exemptions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act, the exemptions on which hedge funds relied. US advisers who manage more than $150 million for one or more "private funds" must now register with the SEC even if their clients and offices are all located within a single state. (Thus the previous "intra-state" exemption has been drastically curtailed.) As noted below, Dodd Frank retained a limited exemption for "foreign private advisers" with fewer than 15 US clients and nominal US AUM, but the regulatory scheme for US advisers with AUM above $150 million is now purged of any vestige of the old exemption for advisers able to shoehorn their investors into fewer than 15 "legal organizations."[11]

Section 211 of the Advisers Act authorizes the SEC to adopt a standard of conduct for advisers when providing advice to "clients." Significantly, though, Dodd Frank amended Section 211 to prohibit the SEC from defining the term "client" to include an investor/owner in a "private fund" that has contracted directly with a US adviser. Thus, outside the context of a limited exemption for "foreign private advisers (see below, page 7), Dodd Frank preserves the ruling of the *Goldstein* Court respecting the legal relationship between an adviser and its contractual client.

New Exemption - Private Fund Advisers Managing Less than $150 million

Dodd Frank added Section 230(m) to the Advisers Act which provides a federal exemption for any US adviser whose clients consist *solely* of "private funds" if the adviser's aggregate AUM for all such funds are *less* than $150 million. Non-US advisers may claim the exemption, regardless of the structure of their non-US funds or the amount of their non-US AUM, if all their US funds are "private funds" and the aggregate value of their AUM in the US is less than $150 million.

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presence of "systemic" risk, real or imagined, was the justification both for the corporate "bailouts" that led to Dodd Frank and for the exponentially increased regulation over financial markets imposed by that statute.

[10] Title IV was included in Dodd Frank after being passed separately as the "Private Fund Investment Advisers Registration Act of 2010."

[11] Technically, a private fund is a "hedge fund" for Advisers Act reporting purposes if it pays performance fees to its adviser, sells securities short, or incurs "gross notional exposure" in excess of twice its net asset value.

Section 203(a)(3) of the Advisers Act defines AUM, or "assets under management," as "the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services." In calculating the $150 million AUM threshold for registration, advisers need include only portfolios or individual securities for which they have management responsibility. Thus an adviser providing services for only part of a portfolio need count only the securities included in that part. On the other hand, advisers must include in the calculation proprietary assets, assets managed without compensation and uncalled capital commitments. All assets are to be valued at market value (or "fair value" in the absence of a market) and on a gross basis, without deducting liabilities such as accrued fees.

Firms relying on the exemption for private fund advisers whose AUM is below the threshold must still maintain records and provide annual and other reports the frequency and content of which are determined by SEC Rules. See **"Limited Reporting Requirements for Exempt Advisers,"** page 9. Accordingly, the practical utility of the exemption remains to be seen. Moreover, these advisers will be subject to regulation under state law. See **"Reallocation of Regulatory Responsibility,"** page 10.

New Exemption - Advisers to Venture Capital Funds

Dodd Frank added Section 203(l) to the Advisers Act to provide a new exemption for advisors who provide services solely to one or more "venture capital funds;" a term that was to be defined by the SEC. The SEC was also directed to require venture capital advisers to maintain such records and furnish such reports as the SEC determined were necessary in the public interest and for the protection of investors. On July 21, 2011, in Release IA-3222, the SEC adopted definitional and implementing Rules briefly summarized as follows:

A "venture capital fund" (i) holds at least 80% of its "capital Commitments" in "qualifying investments" (or in "short term" investments such as cash and equivalents, US Treasury notes maturing in no more than 60 days and shares of registered money market funds); (ii) does not borrow or otherwise incur leverage (other than short-term borrowings and guarantees of certain of the obligations of its "qualifying portfolio companies"); (iii) does not provide investors with redemption rights except in extraordinary circumstances; (iv) represents to its investors and potential investors that it pursues a venture capital strategy; and (v) is a "private fund" (i.e., is not registered under the Investment Company Act and has not elected to be treated as a "business development company").

"Capital commitments" are binding undertakings by investors to purchase interests in a venture capital fund in response to a capital call. "qualifying investments" are equity investments acquired directly from "qualifying portfolio companies" (i.e., privately held operating companies that do not have a control relationship with a public company, or use leverage, or distribute borrowed proceeds to the venture capital fund in exchange for the fund's investment.

The foregoing definitions reflect the SEC's effort to accommodate the practical requirements of the venture industry while distinguishing venture capital funds from other pooled investment vehicles that qualify as "private funds" but are not exempted by Dodd Frank, e.g., hedge funds, private equity funds and leveraged buyout funds. Accordingly, the definitions effectively limit the venture capital exemption to advisers who announce their intent to pursue a venture capital investing strategy and limit their clients to non-leveraged funds that (i) provide equity directly to private, non-leveraged operating companies, (ii) do not offer liquidity to their owners through periodic redemptions; and (iii) do not purchase portfolio securities in the secondary market from exiting early investors. The limited 20% "basket" for a venture fund's non-qualifying investments and short term borrowings is designed merely to provide some financial flexibility without detracting from the fund's overriding venture focus. The venture capital exemption is also available to foreign (non-US) advisers if all requirements for the exemption are satisfied. For example, all clients of the foreign adviser must be venture capital funds.

There is a limited grandfathering provision available for private funds that do not meet all requirements for the venture capital exemption, but had represented to their investors that they were pursuing a venture capital strategy, had sold securities to at least one such investor by December 31, 2010 and have neither sold securities nor accepted capital commitments after July 21, 2011 when Dodd Frank was signed into law. The retroactive dates are designed to prevent circumvention and are justified by the SEC on the ground that a private fund making an 11th hour attempt to qualify for the venture exemption could harm itself and its investors by abruptly changing strategies or fund terms, or liquidating portfolio holdings.

The reporting requirements for venture capital and other advisers that are exempt from SEC registration involve disclosure of (i) identifying information about the adviser, its owners and affiliates; (ii) information about the private funds the adviser manages; (iii) information about other business activities of the adviser or its affiliates that may present conflicts between the interests of the adviser and those of its clients and (iv) the disciplinary history of the adviser and its employees. See, **Reporting Requirements for Exempt Advisers,** page 8.

New Exemption - Foreign Private Advisers

Dodd Frank amended the Advisers Act to provide a limited new exemption for small "foreign private advisers." These advisers (i) have no place of business in the US, (ii) have fewer than 15 US clients and investors in private funds, (iii) have aggregate AUM for US clients and investors of less than $25 million (subject to adjustment by the SEC) and neither hold themselves out to the public as investment advisers nor advise registered investment or business development companies. To determine the number of their US clients and investors, foreign private advisers must count *owners* of their funds as *clients*. In this narrow respect, Dodd Frank overrides the DC Circuit Court of Appeals decision in *Goldstein v. SEC*.

New Exemption - CFTC Registered Advisers

Dodd Frank also amended the Advisers Act to ensure that the elimination of the "private adviser" exemption would not, as such, require registration with the SEC by advisers registered with the Commodity Futures Trading Commission. To accomplish this, Dodd Frank created a new exemption for any CFTC registered adviser that advises a "private fund" other than a registered investment or business development company. The exemption is subject to the obvious caveat that SEC registration would nevertheless be required for any such adviser whose business is or subsequently becomes "predominately the provision of securities-related advice."

Of course, there are experts who, for compensation, provide advice as to the value of property other than securities including, in addition to commodities, such assets as diamonds, precious metals, coins and stamps. The SEC staff has acknowledged that such experts are not investment advisers within the meaning of the Advisers Act. If they provide services to a registered investment company, however, these experts may meet a definition of investment adviser inserted for certain purposes in the Investment Company Act of 1940. That definition includes any person who advises a registered investment company about investing in securities or "other property" or has authority to determine whether the company will purchase or sell securities or "other property." Such a person would be subject to Investment Company Act provisions governing advisory contracts and prohibiting certain transactions with affiliates.[12]

New Exemption - Small Business Investment Company Advisers

Dodd Frank created and fully defined a new exemption for investment advisers who are not regulated as business development companies and whose clients are limited to small business investment companies ("SBICs") licensed as such under the Small Business Investment Act. The SEC's Adopting Release for its Dodd Frank Rules uses the SBIC exemption to illustrate the mutually exclusive nature of all Dodd Frank exemptions with this example: *"Advisers solely to either venture funds or SBICs may be exempt regardless of the amount of assets they have under management, but if their clients include both a venture fund and an SBIC, they could claim neither the venture … fund exemption nor the SBIC exemption....*

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[12] See, www.sec.gov/divisions/investment management/"Issues of Interest" for the staff's views on this subject.

Moreover, if they claim the exemption for advisers to private funds managing less than $150 million, the assets of all their clients, venture capital funds, SBICs or otherwise, must be included in the calculation."

New Exclusion - "Family Offices"

In the context of the Investment Advisers Act, a "family office" is an entity owned and controlled, directly or through one or more "legal organizations," by members of a single family. These offices traditionally engaged in business solely to manage investments and provide other financial services to family members. They neither held themselves out to the public as investment advisers nor provided services to multiple families or to non-family clients.

Prior to Dodd Frank, family offices escaped registration if they met the requirements for the "private adviser" exemption in spirit by adhering to an analogous advisory model. The limits of the analogy were set by SEC no-action letters granting exemption relief to technically non-qualifying firms that refrained from public solicitation, were owned and controlled by a single family and provided investment advisory services exclusively to that family.

Though it eliminated the "private adviser" exemption for others, Congress respected the SEC's position that advisers owned and controlled by and for the exclusive benefit of a single wealthy family should not be required to register under the Advisers Act. Dodd Frank directed the SEC to adopt a definitional Rule consistent with the public interest, the protection of investors and its own no-action history that would distinguish a family office from an advisory firm subject to registration. The SEC complied by adopting Rule 202(a)(11)(G)-1. Under that Rule a family office, together with its directors, executives, partners, other managers, members and key employees, is *excluded* from the *definition* of an investment adviser for the purposes of the Advisers Act if (i) it has no clients except "family clients," (ii) it is wholly owned by such clients and controlled exclusively by family members or their wholly owned entities and (iii) it does not hold itself out to the public as an investment adviser. The Rule defines the key terms as follows:

"Family clients" are current or former family members or key employees and their estates, plus non-profit organizations, charitable foundations, charitable trusts and charitable lead or remainder trusts whose only current beneficiaries are family members and whose funding is provided exclusively by one or more family clients. "Family members" are lineal or adoptive descendants (and their spouses) of a common ancestor no more than 10 generations removed from the youngest current generation and "key employees" are employees of a family office with significant decision-making responsibilities.

The Rule also contains definitions, some of them elaborate, for various related terms (e.g. "spousal equivalent" - a cohabitant occupying a relationship generally equivalent to that of a spouse). There is a grandfathering provision for certain family offices that were neither registered nor required to be registered under the Advisers Act before January 1, 2010, and transition periods that extended the time for full qualification (i) until December 31, 2013 for family offices that would have qualified when Dodd Frank was adopted but for having one or more clients that were not "family clients" and (ii) until March 30 2012 for family offices that qualified prior to Dodd Frank for the "private adviser" exemption. In an exhibit called "Annex A," the Rule incorporates tables showing how families can re-designate the "common ancestor, from time to time, to ensure continued compliance with the 10 generation limitation.

Reporting Requirements for Registered Hedge Fund Advisers

After a transition period that expired March 30, 2012, newly registered hedge fund advisers became subject to the same basic compliance, disclosure and reporting requirements as other SEC registered advisers. The standard reporting regime centers on Form ADV, a documentary interrogation replete with general and specific instructions, appendices, schedules and a glossary of terms. Form ADV is both the initial registration document and, as amended or updated to disclose changes in material information, the periodic reporting document required from advisers by the SEC and state securities administrators. It is divided into four parts:

● Part 1A, with supporting Schedules and "Disclosure Reporting Pages" ("DRPs") solicits identifying and basic business information about the adviser, its affiliates, its direct and indirect owners and all individuals or entities that provide investment advice on its behalf.

● Part 1B solicits additional state-specific information required by state authorities and may be disregarded by advisers that are registered only with the SEC.

● Part 2A requires advisers to prepare narrative brochures for mandatory distribution to advisory clients. The brochures identify the adviser, set forth its contact information, and describe its form of organization and business (with attention to business specialties or limitations). The required information covers the adviser's affiliates, its prime broker and other significant relationships, its code of ethics (a copy must be provided each client on request), its disciplinary history, its investment programs, methods of analysis and strategies (e.g. whether it employs "frequent trading" - which is not defined) its fee structure (including "soft dollar" fees, such as its receipt of free research in exchange for client investments or referrals), the size and composition of its client base, its interest, if any, in investments recommended to clients, all other practices creating potential conflicts of interest (including the means employed by the adviser for mitigating the conflict), any "significant" or "unusual" risks associated with its strategies or programs and any other material information that could affect its advisory relationships with clients. Sponsors of "wrap fee" programs must deliver a special descriptive brochure" to all program clients. (A "wrap fee" is a fee for advisory services that is not based directly on client transactions, but on the client's ratable share of a global fee charged all participants in the relevant program.)

● Part 2B requires advisers to update Form ADV annually and to amend it each time there is a material change in the information it covers.

The Form itself, bearing the ponderous title *"Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers"* begins with an admonition to provide truthful answers and a warning that "False statements or omissions may result in denial of your application, revocation of your registration, or criminal prosecution." The warning is followed by a check-the-box indication of the reason the Form is being submitted, e.g., as an initial application to register with the SEC or one or more states, as an annual updating amendment to the previous fiscal year, etc.

In addition to the expectable contact information, part 1A requires disclosure of such things as days and hours of operation, a list of all websites and the addresses of all places where records are kept, an identification of all foreign financial regulatory authorities with which the adviser (but not its affiliates) is registered and contact information for the advisers principal executives, including its Compliance Officer and any other person authorized to receive information and respond to questions about the Form.

Registered Advisers to Private Funds - Systemic Risk Reporting on Form PF

Registered advisers to "private funds" with total AUM of at least $150 million as of the last date of their most recent fiscal year must furnish additional information on Form PF in accordance with Advisers Act Rule 204(b)-1. Private Fund advisers that exceed the $150 million threshold, but have less than $1 billion under management need complete only section 1 of the Form. However, that Section offers little comfort to secretive advisers. It requires information respecting the size, leverage, investor types and concentration, liquidity and performance for each fund client, plus the advisers' strategy, counterparty exposures and use of trading and clearing mechanisms for each such client that is a hedge fund.

Limited Reporting Requirements for Exempt Advisers

As noted, venture capital and private fund advisers with less than $150 million in AUM and foreign advisers that have no place of business in the US are still exempt from registration with the SEC. However, advisers relying on the first two exemptions (called "exempt reporting advisers") are required by Advisers Act Rule 204-4 to file annually with the SEC, and update periodically, a Form ADV completed with respect only to sections directed specifically to them. At present, these sections call for relatively limited information about (i) the advisers themselves; (ii) the identity of their owners and affiliates; (iii) the funds they manage; (iv) other activities in which they or their affiliates are engaged; (v) their disciplinary histories and (vi) the disciplinary histories of their employees. Given the SEC's propensity for "mission creep," though, we can expect the sections to expand and multiply in due course.

Reallocation of Regulatory Responsibility - $100 MM Threshold for SEC Registration

For years, non-exempt advisers were required to register both with the SEC and with authorities in states in which they did business. Then the Advisers Act was amended by the National Securities Markets Improvement Act of 1996 to allocate regulatory responsibility between the SEC and the States. Non-exempt advisers with less than $25 million in AUM were *prohibited* from registering with the SEC unless they were required to register in more than 30 states. In that event, they could voluntarily register with the SEC and dispense with state regulation. Beginning in 2010 with Dodd Frank, Section 203A of the Advisers Act further reallocated regulatory authority between the SEC and the states. While the prohibition against SEC registration for advisers with less than $25 Million in AUM remained in place, the Section created a new category of "mid-sized" advisers with AUM between $25 million and $100 million. (Both figures are subject to adjustment through SEC Rule making.) Subject to seven enumerated exceptions, mid-sized advisers are prohibited from registering with the SEC if they are required to be registered in the state where they maintain their principal office and are subject to examination by that state. [13]

The exceptions cover (i) advisers to companies registered under the Investment Company Act; (ii) advisers with at least $25 Million in AUM whose clients include a "business development company" under that Act; (iii) advisers to employee benefit plans having at least $200 million of assets; (iv) advisers having a control relationship with and the same principal office as a registered adviser; (v) newly-formed advisers having a reasonable expectation that they will be eligible for SEC registration with the ensuing 120 days; (vi) advisers that would otherwise be obliged to register with 15 or more states (down from 30 states) and (vii) internet advisers whose services are provided through an interactive website.

In short, advisers now register with the SEC unless they are *prohibited* from doing so because they have less than 100 Million in AUM (and do not qualify for one of the *exceptions* mentioned above) or they are *exempt* from SEC registration (e.g. because their clients are limited to venture capital funds or private funds with less than $150 million in AUM). The immediate result of the Dodd Frank amendments is to minimize regulatory overlap while relieving the SEC of responsibility for smaller firms. Whether the states can summon the resources to take on their new burden remains to be seen.[14]

To minimize the risk to advisers of premature registration or de-registration, the 100 million AUM threshold is reasonably flexible. Advisers with AUM at or slightly above the threshold may (but need not) wait until their AUM reaches $110 Million before registering, while advisers whose managed assets are declining may wait until their AUM falls to $90 Million to de-register.

Conduct Rules

Investment advisers are fiduciaries with respect to their clients. Accordingly, they are subject to a variety of standards and oversight rules that require them to act at all times in their clients' best interest. These include provisions that prohibit advisers from using specified advisory contracts or participating in specified securities transactions deemed unfair to clients, require advisers to keep specific records and

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[13] As a practical matter only mid-sized advisers based in Wyoming (which does not have an investment adviser statute) or New York (which does not require periodic examinations of advisers) may apply for SEC registration on the ground that they are not required to be registered and examined by state authorities.

[14] Of course, all advisers are subject to the anti-fraud provisions of the Advisers Act (and its state counterparts) whether or not they must register.

subject advisers to examinations, both with and without notice, by the SEC's Office of Compliance, Inspections and Examinations.

Prohibited Contracts and Transactions

Section 205(a)(1) of the Advisers Act prohibits advisers from entering into contracts that the adviser may assign without the client's consent, or contracts that permit the adviser to receive incentive or performance fees, e.g. through a share of capital gains on or capital appreciation of the funds of a client (as opposed to a fixed percentage of the value of the funds). There are exceptions to the performance fee prohibition for foreign clients, clients that are registered investment or business development companies and clients who are "qualified" by virtue of their net worth, the amount they have under the adviser's management or the aggregate amount of the investments they own or over which they exercise investment discretion.[15]

Affirmative Disclosure Obligations and Record Keeping Requirements

Registered advisers must provide clients directly with a copy of those parts of their Form ADV that disclose their disciplinary history, if they have one, and any conflicts of interest that might prevent them from providing disinterested advice. In addition, the complete Form ADV and all related reports are readily available online through various sources. These include the Investment Adviser Registration Depository ("IARD"), at www.iard.com; the Securities and Exchange Commission ("SEC"), at www.sec.gov/education/check/out/a/broker/or/adviser/research/investment/advisers; and the Financial Industry Regulatory Authority (FINRA), at www.finra.com/broker/check.

Code of Ethics and Compliance Officer

Registered advisers must appoint a Compliance Officer to enforce a written Code of Ethics developed by the adviser in light of its business methods, AUM and investment strategies and to supervise a compliance program designed to prevent, detect and correct violations of the Advisers Act. Since investment advisors (as opposed to broker-dealers) bear a fiduciary relationship to their clients, this is no small task.

Examinations

The SEC's Office of Compliance Inspections and Examinations conducts both scheduled and surprise examinations of registered investment advisers and advisers to private funds to determine their compliance with the Advisers Act and its Rules. In very general terms, the investigations focus on the advisers marketing materials, disclosures and practices, their portfolio management processes, their exposure to conflicts of interest (e.g., through proprietary trading, soft dollar programs and the asset valuations on which their fees are based) and the methods by which they safeguard client assets.

Conclusion

The comprehensive registration, disclosure and SEC reporting rules imposed on investment advisers by Dodd Frank may well put an end to hedge fund secrecy, but the extent to which that will actually benefit the investing public remains to be seen. The Advisers Act has always held advisers to a fiduciary duty with respect to their clients. The securities laws generally are disclosure statutes from beginning to end and they contain formidable criminal enforcement and civil liability provisions that owe nothing to Dodd Frank. Neither the SEC nor the Plaintiffs' bar has hesitated to use those provisions to sanction and

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[15] Rule 205-3 confers "qualified" status currently on (i) clients the adviser reasonably believes have a net worth of $2 Million (exclusive, in the case of natural persons, of home equity), (ii) clients that have $1,000,000 in assets under the adviser's management and (ii) clients that are "qualified purchasers" under the Investment Company Act. The last category includes (A) clients that own not less than $5 Million in aggregate investments and are comprised of married couples or the companies or trusts they own directly or with siblings or lineal descendants and (B) persons (e.g. brokers) acting for their own account or the accounts of other qualified purchasers that own and invest on a discretionary basis not less than $25 Million in aggregate investments. The SEC will adjust those thresholds for inflation on or about May 1, 2016 and thereafter every 5 years.

redress fraudulent investment advisory schemes, inadequately disclosed advisory fees and advisory conduct that disregards conflicts of interest. I think it is an open question whether the elaborate new requirements introduced by Dodd Frank will discourage such behavior, aid in its discovery or merely increase the incidence of false disclosure; an outcome that would leave the SEC ferreting out the truth the old fashioned way.

More importantly, as is often the case with statutes designed to reform whole segments of the economy, compliance with Dodd Frank will be burdensome and expensive. The advisers will pass the expense on to their clients in the form of increased fees. Clients who are not "qualified purchasers" are already denied the high-risk - high-reward investments that encourage advisers to expend prodigious effort to produce extraordinary returns and earn lucrative performance fees. As fees continue to rise, mainstream investors may find it difficult to gain access on attractive terms to any advisory services that extend beyond routine financial planning, asset allocation and guidance respecting garden variety investments.

The cost burden may also be accompanied by a deterioration in securities law enforcement. The SEC is apparently studying a proposal to outsource part of its compliance review function to private contractors. See, Norm Champ, *"Investment Advisers Don't Need Mystery Monitors,"* The Wall Street Journal, November 15, 2015. To me, this is more than modestly alarming. The SEC has been accused both of timid enforcement and overzealous prosecution, but for the most part it has maintained that fine balance between aggression and restraint that is the hallmark of a responsible regulator. If this proposal is put into effect, though, the SEC, having outsourced its reviews, must then supervise the reviewers and verify their conclusions. Done properly, that would defeat the labor-saving purpose of the outsourcing. Done poorly, or erratically, it would bring about an unacceptable reduction in the quality of the review process. Compliance reviews are extraordinarily complex. They are best conducted by experienced and identifiable SEC employees who are subject to public scrutiny. The SEC may be understaffed given the magnitude of its duties, but the solution is to increase its budget to allow it to recruit and train an adequate number of its own examiners.

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