A BRIEF HISTORY OF HEDGE FUND ADVISER REGISTRATION AND ITS CONSEQUENCES FOR PRIVATE EQUITY AND VENTURE CAPITAL ADVISERS

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Historically, hedge fund advisers have not had to register under the Investment Advisers Act of 1940 (the Advisers Act) because of the private adviser exemption. This exemption applied to an investment adviser who (1) had fewer than fifteen clients during the previous twelve months, (2) did not publicly hold itself out as an investment adviser, and (3) did not advise registered investment companies. Even though a hedge fund routinely has fifteen or more investors, hedge fund advisers were able to meet the fewer than fifteen client requirement because they only had to count as clients the funds they advised (which they were careful to keep at fourteen or fewer) and not individual investors in the funds.

As a result, hedge fund advisers were able to avoid the various provisions of the Advisers Act triggered by registration. These provisions include the requirement to disclose specified information to clients, maintain certain business records, permit the Securities and Exchange Commission (SEC) to examine those books and records, make periodic filings with the SEC, and have a corresponding compliance program in place. While hedge funds were exempt from registration, they were subject to the Advisers Act’s prohibition on engaging in fraudulent or deceptive practices, as this provision applies to both registered and unregistered...
investment advisers.9

In light of the growth of hedge funds, hedge fund risk, and malfeasance by hedge fund advisers, the SEC in 2004 determined that hedge fund advisers should have to register under the Advisers Act.10 Hence, it adopted a rule requiring investment advisers of hedge funds to look-through the fund and count as clients the fund’s investors for purposes of the fifteen client threshold.11 As a result, most hedge fund advisers could no longer rely on the private adviser exemption and thus had to register.

This look-through rule went into effect on February 1, 2006 but was short-lived. In June 2006, a federal appeals court held, in Goldstein v. SEC,12 that the rule exceeded the SEC’s authority and was thus invalid. Shortly thereafter and in response, Congressman Barney Frank introduced a bill giving the SEC express authority to adopt a look-through rule, but the bill stalled out in committee,13 as did a similar bill introduced the following year by Senator Grassley.14

Congressional desire to require hedge funds to register under the Advisers Act did not, however, die. Hence, the Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in the wake of the global financial crisis and signed by President Obama in July 2010, included a hedge fund adviser registration provision.15 This provision reflected a different approach. Instead of adopting or authorizing the SEC to adopt a look-through rule, it simply deleted the private adviser exemption from the Advisers Act.16

Given this development, ironically, the private fund industry (hedge funds, private equity funds, and venture capital funds) may have been better off had the SEC prevailed in Goldstein. If the SEC had won, perhaps Congress would not have revisited the hedge fund adviser registration issue in the Dodd-Frank Act, leaving the SEC’s look-through approach in place. The look-through approach was favorable to advisers to private equity funds and venture capital funds, both of which also relied on the private adviser exemption, because the SEC tailored the look-through rule so it did not to apply to them. Specifically, the rule applied only to an adviser of a “private fund,” a term limited to, among other things, a fund that permitted investors to cash out within two years of investing. An investor lockup of

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11 See id. at 72,070.
12 Goldstein v. S.E.C., 451 F.3d 873 (D.C. Cir. 2006).
14 See S. 1402, 110th Cong. (1st Sess. 2007).
16 See § 403.
less than two years is a standard feature of hedge funds but not of private equity funds or venture capital funds.\textsuperscript{17} Because the Dodd-Frank Act deleted the private adviser exemption and does not include a carve out for private equity funds, they are now required to register under the Advisers Act too. Additionally, under the SEC approach, a hedge fund adviser still had the option of avoiding registration by imposing a two-year lockup on its funds. No such option exists under the Dodd-Frank Act approach.

The Dodd-Frank Act did amend the Advisers Act to create a new registration exemption for advisers to venture capital funds and it directs the SEC to define venture capital fund for purposes of the exemption.\textsuperscript{18} The SEC released its proposed definition in November 2010.\textsuperscript{19} The proposed definition, however, is much more elaborate and stringent than the minimum investor lockup concept reflected in the SEC’s look-through rule. To fall under the definition, a fund, among other things, (1) must invest only in equity securities of private operating companies who use the investment proceeds primarily for operating or business expansion capital, hold the proceeds in cash, or invest them in short-term U.S. Treasury securities; (2) cannot be leveraged and its portfolio companies cannot borrow in connection with the fund’s investment; (3) must either control its portfolio companies or offer to provide them significant managerial assistance; (4) must not provide its investors with redemption rights except in extraordinary circumstances; and (5) must represent itself to investors as being a venture capital fund.\textsuperscript{20} Thus, assuming the SEC adopts this definition as proposed, a venture capital fund adviser will have to constrain the fund’s activities to avoid having to register under the Advisers Act. For example, the fund will not be able to make debt investments in private companies or private investments in public companies—both of which some venture capital funds have done in the past—as these types of investments would, at a minimum, violate criteria (1) above.\textsuperscript{21}

Additionally, as part of the venture capital fund adviser exemption, the Dodd-Frank Act directed the SEC to require exempt venture capital fund advisers to maintain records and provide reports as dictated by the SEC.\textsuperscript{22} Further, as the SEC

\textsuperscript{17} See Look-through Rule Release, supra note 10, at 72,074.

\textsuperscript{18} See Dodd-Frank Act § 407.


\textsuperscript{20} See id. at 13.

\textsuperscript{21} Note that the proposed definition of “venture capital fund” incorporates a grandfathering provision to include within the definition “any private fund that: (i) represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011.” Id. at 56.

\textsuperscript{22} See Dodd-Frank Act § 407; see also Rules Implementing Amendments to the Investment Advisers Act of
noted in its release proposing the definition of venture capital fund, exempt venture capital fund advisers will now be subject to SEC examination.\textsuperscript{23} Although the Dodd-Frank Act did not specifically provide for this, it is so because the language that exempts exempt advisers from the examination requirement does not apply to advisers exempt from registration under the venture capital exemption.\textsuperscript{24} Hence, even though the Dodd-Frank Act included an exemption for venture capital fund advisers, its effect is quite a bit narrower than the deleted private fund adviser exemption.

In conclusion, I do not want to give the impression that having to register under the Advisers Act is dire for an adviser to a hedge fund, private equity fund, or venture capital fund. The requirements triggered by registration are not particularly onerous, and presumably registration provides some benefits to fund investors and maybe even helps the government reduce systemic risk. The real question is whether the costs of this regulation outweigh the benefits. Private fund advisers have always been able to voluntarily register, and some hedge fund advisers have done so. The fact that most have not is perhaps evidence that private fund investors believe that the costs—most of which would likely be passed on to them—do exceed the benefits.

\textsuperscript{1940} Investment Advisers Act Release No. 3110, 17 C.F.R. pt. 275, 279, at 35–46 (proposed Nov. 19, 2010), for the SEC’s proposed requirements under this provision.

\textsuperscript{23} See Venture Capital Fund Adviser Exemption Release, supra note 19, at 8.

\textsuperscript{24} Section 204(a) of the Advisers Act requires an investment adviser to maintain records and provide reports as dictated by the SEC unless the adviser is exempt from registration by § 203(b) of the Advisers Act. See Advisers Act § 204(a), 15 U.S.C. §80b-4(a). While the private advisers exemption was a § 203(b) exemption, the venture capital fund adviser exemption is not; the Dodd-Frank Act added it to the Advisers Act as § 203(l). See Dodd-Frank Act §407.