

Regulation Overview

SEC Rule 203(b) (3)-2



SEC RULE 203(b) (3)-2

On September 29, 2003, the SEC issued a report on the "Implications of the Growth of Hedge Funds" (the "Report"). The Report raised several issues related to hedge funds and proposed a number of regulatory initiatives that the SEC might take. Its principal recommendation was that the SEC should require most hedge managers to register as investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act").

On July 14, 2004, after a lengthy period of public comment on the Report, the SEC ("Commission") adopted Rule 203(b)(3)-2, which implements this registration recommendation. It set a two-month period for public comment before formally adopting the Rule on December 2, 2004.

In support of Rule 203(b)(3)-2, the SEC argues that requiring the registration of hedge fund advisers is necessary to protect "...investors in hedge funds, and to enhance the Commission's ability to protect our nation's securities markets." The Commission cites two concerns about hedge funds: the growing incidence of fraudulent activity by fund advisers and the "retailization" of hedge fund investments.

Rule 203(b)(3)-2 requires the registration of most advisers to hedge funds with the SEC. The Commission argues that the proposed Rule is a necessary response to its concerns about fraudulent conduct among hedge fund advisers and the growing "retailization" of hedge funds.

On June 13, 2007, the SEC unanimously approved eliminating the grandfathering provision of the close-out requirement of Rule 203(b)(3) of Regulation SHO. Rule 203(b)(3) requires broker-dealers to buy-in their fails of threshold securities (those securities with a significant amount of fails to deliver at a clearing agency) after 13 days of settlement failure. In eliminating this exception, brokerdealers will now be required to close-out their fails within 13 days of a security becoming a threshold security regardless of when the sale or failure to deliver occurred.

WHO IS AFFECTED BY SEC RULE 203(b) (3)-2?

There is no precise definition of "hedge fund" under federal securities laws. In practice, the term "hedge fund" generally refers to an unregistered pooled investment, privately organized, not advertised, and administered by professional investment managers, whose securities are privately placed with wealthy individual and institutional investors. As unregistered investment pools they are exempt from the laws and regulations that apply to registered investment vehicles (such as mutual funds) and as a consequence are able pursue investment strategies that differ from many other investment vehicles (which is their primary attraction to investors).

Rule 203(b)(3)-2 amended the existing private adviser exemption under Rule 203(b)(3) by changing the definition of "client" in a way that would require most hedge fund advisers to register under the Advisers Act. Specifically, it would require that each owner of a "private fund" (and each individual investor) be counted as a client. As previously discussed, under existing rules a hedge fund (or limited partnership) was treated as a single "client," even though the hedge fund might have dozens of investors (or limited partners). Under the new rule an adviser to a single hedge fund with 15 or more limited partners (investors) would now be viewed as having more than 14 clients and would be required to register under the Advisers Act unless it had no more than \$25 million under management.

Registered "hedge funds" are closed-end (mutual) funds registered under the 1940 Investment Company Act which pursue hedge fund investment strategies (more often a fund-of-(hedge)-fund strategy). Publicly-offered, registered, hedge funds are those that have registered their securities under the 1933 Securities Act.

WHAT ARE THE REQUIREMENTS OF SEC RULE 203(b) (3)-2?

Hedge fund advisers are required to retain whatever records they do have that support the performance they earned prior to their registration, but are excused from the recordkeeping rule to the extent that those records are incomplete or otherwise do not meet the requirements of Rule 204-2.

SEC examiners require access to records to determine whether a hedge fund adviser is meeting its fiduciary obligations to a private fund under the Advisers Act and rules. The books and records of a registered hedge fund adviser include records of the private funds for which the adviser acts as investment adviser and the adviser or a related person acts as general partner, managing member, or in a similar capacity.

WHEN IS SEC RULE 203(b) (3)-2 EFFECTIVE?

The effective date of new rule 203(b)(3)-2 and amendments to rules 203(b)(3)-1, 203A-3, 204-2, 205-3, and 222-2 is February 10, 2005. Hedge fund advisers must currently be in compliance with Rule 203(b)(3)-2.

WHAT ARE THE PENALTIES FOR SEC RULE 203(b) (3)-2?

Criteria for compliance are strict and penalties for violation severe. The SEC fined five of the largest investment banks in the world over USD \$8 million for having inadequate procedures and systems in place for the retrieval of email as defined by SEC 17a-4. Goldman, Sachs & Co., Citigroup Inc.'s Salomon Smith Barney, Morgan Stanley & Co., Deutsche Bank Securities Inc., and U.S. Bancorp Piper Jaffray Inc. all agreed to pay, and to review and report on procedures for email retention. These penalties foreshadow potential industry penalties of more than USD \$1 billion, and individual fines up to USD \$500 million for some brokerages. The penalties for non-compliance include not only fines, but also license suspensions or revocations.

HOW DO FIRMS COMPLY WITH RULE 203(b) (3)-2?

The following are simplified requirements for Rule 203(b) (3)-2. Firms must enact policies or implement technologies to enable:

- Archival of an original copy of all records, including those created in email
- Written and enforceable retention policies
- Storage of data on indelible, non-rewriteable media
- Searchable index of all stored data
- Readily retrievable and viewable data
- Rules and permission levels for access to records

WHAT DOES ZL TECHNOLOGIES PROVIDE?

ZL Technologies' compliance platform provides a comprehensive set of tools to comply with Rule 203(b) (3)-2, including:

- Email archiving and WORM storage
- Email retention policy management
- Email search and discovery
- Email storage management
- Email attachment management
- Permissions-based access to email

ZL Technologies provides an all-in-one solution which stores data on virtually any non-rewriteable device (CD-R, DVD-R, and magneto optical disc, et al). A comprehensive and hierarchically searchable index is automatically generated for headers, message body, size, and attachments. By providing a full auditor application, ZL Technologies enables internal or external auditors to capture specific mails and generate an annotated thread for tracking the entire review lifecycle. ZL Technologies can capture all email records, store them in a tamper-proof way, maintain privilege-based access control to data, and allow quick, compound searches, discovery, and retrieval for administrators and auditors.

While ensuring the highest levels of security is a primary consideration, the day-to-day practicality and usability of our solution is also at the forefront of our design considerations.

To address this requirement, ZL's solution is completely gateway and server based making it transparent to senders. Since there is no change in user experience, no training is necessary. In addition, ZL does not require recipients to download or install any software, applets, or ActiveX components onto their system. While many other solutions might claim they do not require any downloads, they might require applets or other installed components to run properly, potentially interfering with network firewalls and certain operating systems. ZL truly requires no such downloads, transparent or otherwise.

Administrators benefit from a fully automated system, which can be set to manage the entire life cycle of registering, maintaining, and renewing users. ZL Technologies' full suite of automated end-user registration and authentication technologies provide maximum flexibility by tying to existing standards such as SSO, SAML, LDAP, Active Directory, and other centralized authentication schemes. These can be stored on directory servers, databases, PIN servers, or other structures. ZL Technologies also enables self-administration by users of their passwords or keys depending upon which security module is deployed. The burden for administrators operating the system is dramatically reduced.

With compliance capabilities tightly matched to the requirements of 203(b) (3)-2, as well as SEC regulations, ZL Technologies helps meet the regulatory compliance needs of investment advisors and their firms.

ABOUT ZL TECHNOLOGIES

Established in 1999, ZL Technologies, Inc. (ZL) provides cutting-edge enterprise software solutions for email archiving, regulatory compliance, litigation support, corporate governance, content management, file archiving, and secure email. ZL's flagship product, the Unified Archive, offers comprehensive email and file archiving and management for companies using Lotus Notes/Domino, Microsoft Exchange, Bloomberg, and others. The suite provides a highly flexible framework that is fully scalable, enabling organizations of all sizes to meet legal discovery, compliance, and storage management requirements. With a proven track record and an impressive list of clients, including Walgreens, Bank of New York Mellon, Pacific Life, and Morgan Keegan, among other top global institutions, ZL has emerged as the premier provider of email archiving and compliance solutions. For more information, please visit www.ZLTI.com

To learn more about how ZL Technologies can help you take control of your data, call us at 408.240.8989 or visit us online at www.ZLTI.com