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Client
Alert

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SEC Adopts Rules Requiring Registration of Hedge Fund Advisers by February 1, 2006

The Securities and Exchange Commission has adopted new rules that will require many investment advisers to hedge funds to register with the Commission under the Investment Advisers Act. The new rules generally will become effective on February 10, 2005. However, in order to afford hedge fund advisers sufficient time to prepare for registration and regulation, the SEC has designated February 1, 2006, as the "compliance date" by which hedge fund advisers must register with the Commission.

This *Client Alert* highlights key provisions of the new registration rules and the substantive Advisers Act requirements that will apply to registered hedge fund advisers. *As we discuss below, we strongly recommend that hedge fund advisers evaluate the new requirements now and, if they determine to register, begin the extensive preparations that may well be necessary to adapt successfully to registration and regulation under the Advisers Act.*

The New Registration Requirement

Section 203(b)(3) of the Advisers Act provides an exemption from registration, known as the "private adviser exemption," for an investment adviser that has had fewer than 15 clients during the preceding 12 months, and neither holds itself out generally to the public as an investment adviser nor advises a registered investment company. Previously, Rule 203(b)(3)-1 under the Act generally permitted an adviser to count as a single client a corporation, trust or other legal organization to which the adviser gives investment advice based on the organization's investment objectives, rather than those of its underlying investors. In the past, this rule has enabled many hedge fund advisers to rely on the private adviser exemption.

However, newly adopted Rule 203(b)(3)-2 (and amendments to Rule 203(b)(3)-1) abandon this approach in favor of a "look through" provision requiring that, for purposes of the private adviser exemption, the shareholders, partners, limited partners, members and beneficiaries (collectively, the "investors") in a "private fund," as defined, must be separately counted as clients of the fund's investment adviser. A "private fund" is a company: (i) that would be an "investment company" as defined in the Investment Company Act but for the exemptions in Section 3(c)(1) or 3(c)(7) thereof (for privately offered funds held by, respectively, not more than 100 persons or only qualified purchasers); (ii) that permits its investors to redeem any portion of their investment interests within two years of the purchase of such interests; and (iii) interests in which are, or have been, offered based on the investment advisory skills, ability or expertise of the investment adviser. Private funds within this definition are referred to below as hedge funds. A fund that does not meet all of these requirements is not a "private fund."

Counting Clients. As a result of the new rules, as of February 1, 2006, a hedge fund adviser that as of that date has 15 or more clients, including investors in its hedge fund(s) as discussed above, must be registered with the Commission. In counting hedge fund investors for this purpose, a hedge fund adviser can exclude itself, those of its advisory personnel who are "qualified clients" (see *Performance Fees* below), and the hedge fund. An adviser to a hedge fund in which a registered investment company invests (i.e., a "fund of hedge funds") must count the underlying investors in the registered fund as the adviser's own clients. This provision is intended to prevent an unregistered hedge fund adviser from providing services to a large number of mutual fund investors through 14 or fewer mutual funds.

Redeemability Within Two Years. As discussed above, by definition a "private fund" permits investors to redeem some portion of their interests in the fund within two years (determined on a FIFO basis) after their purchase. Conversely, a fund is not a "private fund" if it "locks up" for at least two years, except in "extraordinary circumstances," all investments except those representing reinvested income or capital gain distributions. To avoid "private fund" status, a fund need apply such a lock-up only to investments made on or after February 1, 2006. Examples of acceptable "extraordinary circumstances" include the provisions in many private equity partnership agreements permitting an investor to redeem in the event that maintaining the investment becomes impractical or illegal, or the investor dies or becomes disabled, or key personnel of the adviser cease to be involved in the management of the fund for an extended period of time. In addition, the lock-up need not apply to distributions initiated by the general partner or investment adviser and payable to all investors (or a class of investors) in accordance with the fund's governing documents, or to an investor's transfer of its investment (to a new limited partner, for example) in a secondary market transaction.

The Adviser's Skills, Ability or Expertise. By definition, a fund is a "private fund" only if interests in the fund are, or have been, offered based on the investment advisory skills, ability or expertise of the investment adviser. Such a fund is deemed to retain this characteristic even though its adviser delegates the advisory function to subadvisers or utilizes a "manager of managers" structure.

Assets Under Management; State Regulation. By virtue of the new rules, a hedge fund adviser that previously has relied on the private fund exemption may, depending on the size and mix of its business, be obliged to register with the SEC. A CFTC-registered commodity trading advisor need not register with the SEC as an investment adviser if its business does not consist primarily of acting as an investment adviser. A hedge fund adviser that maintains its principal office and place of business in the United States and has less than $25 million under management generally will not be eligible to register with the SEC (unless its principal office and place of business is in Wyoming, the only state that does not regulate investment advisers). A hedge fund adviser managing between $25 and $30 million is eligible, but not required, to register with the SEC, while a hedge fund adviser managing $30 million or more must (unless still exempt) register with the SEC. For purposes of computing a hedge fund adviser's assets under management, the total assets in securities portfolios, unreduced by amounts borrowed to acquire such assets, are considered, but an adviser's proprietary assets and assets attributable to non-U.S. investors need not be counted.

An adviser that is not registered with the SEC may be obliged to register with the state in which it maintains its principal office and place of business and, depending on the laws of the states in question, possibly additional states in which it maintains a place of business or has had during the preceding 12 months at least 6 clients (excluding for this purpose hedge fund investors). Once registered with the SEC, an adviser is exempt from state regulation, but remains subject to state "notice filing" (and filing fee) requirements and state investigation and enforcement proceedings with respect to fraudulent or deceptive practices.

Offshore Advisers and Funds. The new rules include provisions intended to limit their extraterritorial effect. An offshore hedge fund adviser (i.e., one whose principal office and place of business is outside the U.S.) need count only those of its clients (including investors in its "private funds," as defined above) that are U.S. residents in determining whether it has more than 14 clients. (For this purpose, a "private fund" investor's residence can be determined as of the time of investment in the fund.) In turn, the definition of "private fund" excludes a fund that has *its* principal office and place of business outside the United States, makes a public offering of its securities in a country other than the United States, and is regulated as a public investment company under the laws of that country, even though its investors may include any number of U.S. residents.

Finally, the new rules permit an offshore adviser to an offshore "private fund" to treat the fund (as opposed to the fund's investors) as its client for all purposes under the Advisers Act *except* the private adviser exemption and the Act's antifraud provisions. This provision is intended to relieve an offshore adviser from most of the Act's requirements with respect to its offshore funds and other non-U.S. clients. A registered offshore hedge fund adviser relying on this provision will be required to keep certain books and records (including its access persons' personal securities transaction reports), and is subject to the SEC's examination authority. If the adviser has no U.S. clients (except for private adviser exemption counting purposes), it is not subject to other Adviser Act regulations, such as those regarding compliance policies and procedures, custody, proxy voting, "brochure" delivery, advisory contracts, performance fees, advertising, solicitation payments and codes of ethics.

Registration with the SEC-Form ADV

In order to register with the SEC, a hedge fund adviser must file Part I of Form ADV electronically through the

Investment Adviser Registration Depository (or "IARD"). Part I elicits information about an adviser's business, the persons who own or control the adviser, and the disciplinary history of the adviser and its personnel. The new rules include amendments to Form ADV requiring hedge fund advisers to identify themselves as such. The SEC generally has 45 days after receipt of Part I to grant (or institute proceedings to deny) an adviser's registration.

Regulation Under the Advisers Act

Once registered, a hedge fund adviser becomes subject to regulation under the Act and rules thereunder. Significant regulatory requirements applicable to registered advisers are summarized below.

Disclosure to Investors. Rule 204-3 requires an adviser to deliver (or offer to deliver) to prospective clients, and to existing clients annually, a brochure containing at least the information about the adviser's business practices, fees and potential conflicts of interest required by Part II of Form ADV. Rule 206(4)-4 requires an adviser to disclose to clients and prospective clients certain disciplinary history and any financial condition that is reasonably likely to impair the adviser's ability to meet its contractual commitments to clients.

Compliance Policies and Procedures; Chief Compliance Officer. Rule 206(4)-7 requires an adviser to adopt and implement written policies and procedures reasonably designed to prevent violation of the Act and rules thereunder, to review such policies and procedures at least annually for their adequacy and effectiveness, and to designate a Chief Compliance Officer responsible for administering the policies and procedures. The SEC has identified matters that, "at a minimum," an adviser's written policies and procedures should address. These include portfolio management processes, trading practices, proprietary trading, personal trading activities, accuracy of disclosure, safeguarding of client assets, recordkeeping, marketing, portfolio evaluation, privacy protections and business continuity plans.

Performance Fees. Rule 205-3 permits an adviser to charge performance fees based on a fund's capital gains or appreciation only to a "qualified client." The rule's definition of this term is limited generally to a client placing at least $750,000 under the adviser's management or possessing net worth of at least $1.5 million. In order to avoid disrupting a hedge fund adviser's existing performance fee arrangements, an amendment to Rule 205-3 "grandfathers" performance fee arrangements with clients (including for this purpose investor accounts in "3(c)(1) funds") that exist before February 10, 2005.

Books and Records. Rule 204-2 requires an adviser to maintain and preserve specified books and records relating to its business, which are subject to examination by the Commission pursuant to Section 204 of the Act. The new rules include amendments to Rule 204-2 to clarify that for purposes of the Commission's examination authority, the records of an adviser include the records of hedge funds for which the adviser (or a related person of the adviser) acts as general partner or managing partner, or in a similar capacity. Under Rule 204-2, an adviser that promotes its performance track record must retain the documentation supporting such performance claims for five years after the performance information is last used. A "grandfathering" amendment to the rule requires newly registering hedge fund advisers to retain whatever records they do have that support their performance records prior to registration, but excuses them from Rule 204-2 to that extent that such past records fall short of the rule's requirements.

Code of Ethics. Rule 204A-1 requires an adviser to adopt a code of ethics that sets standards of conduct for advisory personnel and addresses conflicts of interest arising from personal trading by advisory personnel.

Custody; Audited Fund Financials. Rule 206(4)-2 requires an adviser that has custody of client assets to maintain certain controls and procedures. Under the rule, an adviser acting as general partner of a limited partnership, managing member of a limited liability company, or comparable position for other form of pooled investment fund is deemed to have custody of the fund's assets. A hedge fund adviser having custody of fund assets is deemed to satisfy the rule's custody account information obligations if the fund annually delivers audited financials for the fund to its investors within 120 days after the fund's fiscal year end. An amendment to the rule lengthens the 120-day deadline to 180 days for a "fund of hedge funds" that invests at least 10% of its total assets in unrelated pooled vehicles.

Solicitation Payments. Rule 206(4)-3 requires advisers to observe certain procedures and restrictions with respect to cash payments to persons who solicit clients for, or refer clients to, the adviser.

Proxy Voting. Rule 206(4)-6 requires an adviser that has authority to vote any client securities to adopt written policies and procedures that describe how the adviser addresses material conflicts that may arise between its interests and those of its clients, and are reasonably designed to ensure that the adviser votes securities in the best interest of clients. The rule requires the adviser to disclose to clients certain information about these policies and procedures.

The Need for Adequate Preparation

As noted above, in order to afford hedge fund advisers sufficient time to prepare for registration and regulation under the Advisers Act, the SEC has designated February 1, 2006, as the "compliance date" by which hedge fund advisers must be registered with the Commission. However, it will be important that a hedge fund adviser allow sufficient time and commit the resources necessary to determine whether registration is required and, if so, to adapt successfully its business and operations to Advisers Act regulation. In particular, Rule 206(4)-7, which is discussed above under *"Compliance Policies and Procedures; Chief Compliance Officer,"* is a relatively new rule that has proven to require extensive preparations, even for investment advisers long registered under the Act. Addressing this rule, the SEC has stated that "each adviser, in designing its policies and procedures, should first identify conflicts and compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks." Even firms not required to register may wish to consider the impact of these new rules on "best practices."

We would be happy to discuss with you any of the issues raised in this *Client Alert*. If we can be of assistance, please contact the lawyers listed below.

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