K&L ALERT

Investment Management

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# SEC Changes Registration Requirements Under the Advisers Act for Certain Hedge Fund Advisers

On December 2, 2004, the Securities and Exchange Commission (the "SEC") issued the final version of the rule and rule amendments that will, as of February 1, 2006, require many hedge fund advisers to register as investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"). In summary, the rules generally require hedge fund advisers to register as investment advisers if 15 or more people or entities have invested in the hedge funds they manage, or otherwise are investment advisory clients. For this purpose, a hedge fund is a private fund that permits investors to redeem their interests within two years after purchase.

The rule will have important effects on hedge fund managers that are required to register under the rule. Among other things, those advisers will become subject to the registration, record-keeping, Form ADV delivery, custody, and other requirements of the Advisers Act. They also must adopt compliance policies and procedures and codes of ethics, and must appoint a chief compliance officer. Perhaps most importantly, they must develop and instill in their employees a "culture of compliance" that may be far more formal and rigid than their current operations.

Some hedge fund advisers likely will consider revising their fund structures so that their investors will be subject to a two-year lock-up period, which would permit those advisers to avoid registration. Time will tell how the market and investors react to these long lock-up periods, and whether registered advisers will gain a significant competitive advantage by being able to offer their hedge fund investors immediate liquidity.

The remainder of this alert summarizes the key provisions of the new rule and rule amendments. However, we expect that there will be many questions that are left unanswered by the new rules, and we anticipate that the SEC staff likely will be called upon to address a variety of interpretive issues under the rules prior to their implementation.

## DOMESTIC HEDGE FUNDS

### *Counting Owners*

Rule 203(b)(3)-2 requires investment advisers to count each owner of a "private fund" toward the threshold of 14 clients for purposes of determining the availability of the private advisers exemption of Section 203(b)(3) of the Advisers Act. As of February 1, 2006, an adviser to a "private fund" will no longer be able to rely on the private adviser exemption if the adviser, during the course of the preceding 12 months, has advised private funds that had more than 14 clients; each shareholder, limited partner, member, or beneficiary of the private fund must be included in this calculation (subject to certain exceptions). Furthermore, an adviser that advises individual clients directly must count those clients together with the investors in any private fund it advises in determining its total number of clients for purposes of Section 203(b)(3).

A hedge fund adviser whose investors include a fund of funds that is itself a "private fund" must apply the general provisions of the new rule, which compel looking through the top tier private fund and counting its investors as clients for purposes of the private adviser exemption. It should be noted, however, that the SEC will permit a hedge fund adviser to exclude from the calculation certain knowledgeable advisory personnel and related persons.

### *Definition of "Private Fund"*

The SEC will now define a "private fund" by reference to three characteristics that it believes are shared by virtually all hedge funds, and that differentiate hedge funds from other pooled investment vehicles such as private equity funds, venture capital funds, and pension plans.

1. *Sections 3(c)(1) and 3(c)(7).*
   A fund will not be a "private fund" unless it is a company that would be subject to regulation under the Investment Company Act of 1940 but for the exceptions from the definition of "investment company" provided in Section 3(c)(1) or Section 3(c)(7) of that Act. Thus, advisers are not required to "look through" most clients that are business organizations, including insurance companies, broker-dealers and banks, as well as bank common trust funds and bank collective investment funds.
2. *Redemption Within Two Years.*
   A company will be a private fund if it permits investors to redeem their interests within two years of purchase. The rule does allow a fund to offer redemption rights under extraordinary circumstances without being considered a private fund. Advisers must apply the two-year redemption test to any investments made on or after February 1, 2006, whether those investments are made by new or existing investors.
3. *Advisory Skills, Ability, or Expertise.*
   A company will be a private fund only if interests in it are offered based on the investment advisory skills, ability, or expertise of the investment adviser.

### *Calculation of Assets Under Management*

Rule 203(b)(3)-2 does not alter the minimum amount of assets under management that an investment adviser generally must have in order to register with the SEC. A hedge fund adviser whose principal office and place of business is in the United States cannot (subject to certain exceptions) register with the SEC unless it manages assets of at least $25 million. An adviser to a private fund may also exclude the value of proprietary assets as well as the value of assets attributable to non-U.S. persons when calculating the firm's assets under management for purposes of the $25 million registration threshold.

### *Changes to Performance Fee Rule*

The SEC added grandfathering provisions to Rule 205-3 under the Advisers Act, the performance fee rule, to avoid disrupting existing arrangements between newly-registered hedge fund advisers and their current pool investors or separate account clients. Most hedge fund advisers charge a performance fee based on their funds' capital gains or appreciation; however, the SEC's rules permit registered investment advisers to charge performance fees only to "qualified clients." The SEC has revised Rule 205-3 to permit existing investors in any 3(c)(1) fund to retain their investment and to add to it even if they are not qualified clients, and to permit the newly-registered advisers to continue advisory contracts they may have with other clients that are not qualified clients, so long as the clients invested or entered into investment management contracts before February 10, 2005.

Hedge fund advisers that are required to register with the SEC starting on February 1, 2006, are permitted to market their performance from periods prior to their registration with the SEC, even if they have not maintained documentation that the SEC's rules would otherwise require.

## OFFSHORE HEDGE FUNDS

### *Counting Owners*

As of February 10, 2005, Rule 203(b)(3)-2 imposes the same counting requirements on offshore advisers to hedge funds as it does on offshore advisers providing advice directly to U.S. clients. Thus, for purposes of eligibility for the private adviser exemption, an offshore hedge fund adviser must look through each private fund it advises, whether or not those funds are also located offshore, and count each investor that is a U.S. resident as a client. An offshore adviser that, during the course of the preceding 12 months had more than 14 U.S. clients, including clients that invest in a hedge fund advised by the adviser, generally must register with the SEC under the Advisers Act. If an investor is a non-U.S. client at the time of the original investment, the adviser may continue to count the investor as a non-U.S. client even if the investor subsequently relocates to the United States.

### *Calculation of Assets Under Management*

An offshore adviser must register with the SEC by February 1, 2006 if it has more than 14 clients who are residents of the United States, regardless of the amount of assets the adviser has under management. An adviser may not reduce the value of assets under management by deducting amounts borrowed to acquire them.

### *Advisers to Offshore Privately Offered Funds*

Rule 203(b)(3)-2 also provides that an offshore adviser to an offshore private fund may treat the fund (and not the investors) as its client for most purposes under the Advisers Act (other than for purposes of counting investors). The SEC does not apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of an offshore adviser. Yet, unless eligible for an exemption, the offshore adviser will be required to register under the Advisers Act, keep certain books and records, and remain subject to examinations by SEC staff. Certain other requirements, including the Advisers Act's compliance rule, custody rule, and proxy voting rule, would not apply to the registered offshore adviser, assuming it has no U.S. clients other than as investors in one or more offshore funds.

### *Advisers to Offshore Publicly Offered Funds*

Rule 203(b)(3)-2 includes an exception to the definition of "private fund" for a company that has its principal office and place of business outside of the United States, makes a public offering of its securities in a country outside of the United States, and is regulated as a public investment company under the laws of a country other than the United States.

## STATE REGISTRATION REQUIREMENTS

These amendments to the Advisers Act relate to federal registration only. These amendments, including the new "look through" counting procedures, do not change the way clients are counted for purposes of the national investment adviser *de minimis* standard (the standard for determining whether an investment adviser must register with one or more states).

## OTHER MATTERS

### *Code of Ethics Deadline Extension*

Registered investment advisers must have a code of ethics applicable to supervised persons, which requires access persons to submit reports of personal securities transactions and holdings. In order to allow sufficient time for the access persons of hedge fund advisers to receive their year-end brokerage statements and to submit such holdings reports, the SEC extended the compliance date for compliance with code of ethics Rule 204A-1 from January 7, 2005, to February 1, 2005.

### *Custody Rule Amendments*

The SEC amended the Advisers Act custody rule effective January 10, 2005, to permit advisers to funds of funds that elect to distribute audited fund financial statements to investors under the custody rule to distribute such financials no later than 180 days after the end of the fiscal year. For this purpose, a fund of funds is a private fund that invests 10 percent or more of its total assets in a private fund advised by an unrelated entity.

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