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SEC PROPOSES NEW RULE TO REGISTER HEDGE FUND ADVISERS

From the Investment Management Group

The Securities and Exchange Commission ("SEC") has proposed Rule 203(b)(3)-2 (the "Rule") under the Investment Advisers Act of 1940 (the "Act") in order to require advisers to hedge funds with at least $25 million in assets under management to register as investment advisers under the Act.[1] The SEC cited as reasons for the Rule the growing amount of assets invested in hedge funds, the increasing significance of hedge funds in the US securities markets, the rise in the number of hedge fund fraud enforcement cases and the increased exposure of smaller investors in hedge funds. The Rule seeks to bring hedge funds under the regulatory scheme of the Act by requiring investment advisers to count as "clients" each investor in certain unregistered investment funds for which they provide advice. Importantly, however, the Rule does not seek to cover persons who advise private equity funds, venture capital funds, or similar funds that require investors to make long-term capital commitments (i.e., greater than two years).

The purposes of the Rule as stated by the SEC include the following:

- ***Access to information:*** Registered advisers provide the SEC with access to reliable, current and complete information regarding hedge fund investment advisers, including, for example, the number of hedge funds an investment manager advises, the amount of assets in a particular hedge fund and the identity of the hedge funds' control persons and affiliates.

- ***Ongoing oversight and deterrence of fraud:*** According to the SEC the expansion of regulatory coverage over hedge funds will significantly deter the occurrence of fraud and other inappropriate behavior by investment advisers and their affiliates. Registered advisers are subject to SEC examination enabling the SEC staff to examine the activities of investment advisers and hedge funds for harmful practices and/or fraud. In addition, regulation under the Act necessitates the adoption and implementation of internal controls and procedures and the appointment of a chief compliance officer.

- ***Ensuring adviser fitness:*** By requiring registration the SEC seeks to ensure that advisers (or their affiliates) have not committed any felonies and do not have any disciplinary records that would make them unfit to serve as investment advisers.

- ***Ensuring investor fitness:*** Requiring registration will result in the imposition of uniform minimum standards for hedge fund advisers who charge a performance fee; investors will be required to either have a greater than $1.5 million net worth or maintain assets under management with the adviser of at least $750,000.

Who is covered by the Rule? Much of the Rule's import comes from the expanded scope of the term "client" for purposes of being required to register with the SEC. Currently, investment advisers are able to count an investment fund, and not the fund's underlying investors, as one client for purposes of qualifying for the "private adviser exemption" (i.e., under Section 203(b)(3) investment advisers with fourteen or fewer clients in the preceding 12 months, and who do not hold themselves out to the public as investment advisers, are exempt from registration with the SEC). Rule 203(b)(3)-1 permits an adviser to treat an investment vehicle such as a partnership, or limited liability company, as a single client if the adviser provides advice to the investment vehicle based on the vehicle's investment objectives, rather than those of its limited partners, or members, as applicable. As proposed, the Rule would allow the SEC to look through certain "private funds" and count each underlying investor of such private funds as a client for purposes of this exemption. Thus, an adviser to a "private fund" would be required to register if the adviser, during the course of the preceding 12 months, advised a private fund that had more than 14 investors.

A fund will qualify as a "private fund," and each underlying investor will be counted as a client for purposes of the private adviser exemption, if it satisfies the following three criteria:

1) It must be a company otherwise subject to regulation under the Investment Company Act of 1940, as amended (the "ICA") but for its exclusion under either Section 3(c)(1) or 3(c)(7) of the ICA;

2) It must permit its investors to redeem their interests in the fund within two years (however, divestment for certain extraordinary circumstances will not trigger this condition); and

3) The fund's interests must be subject to the ongoing advisory skills, ability and expertise of the investment adviser (e.g., usually evidenced by emphasis on the record of the fund's manager).

Related Rule Amendments Proposed by the SEC

Rule 203(b)(3)-1: As discussed above the Rule permits the SEC to look through "private funds" for determining the number of clients whose assets a given adviser manages. Therefore, certain "private funds" will no longer be able to rely on paragraph (a)(2)(ii) of Rule 203(b)(3)-1 to count the fund as a client as opposed to the underlying investors in such fund.

Rule 204-2: Advisers are required to maintain records supporting their use of performance information.[2] In order not to disadvantage advisers to hedge funds who seek to use performance information for a period prior to SEC registration, the SEC is proposing to require these new registrants to retain whatever records they do have that support the performance they earned prior to their SEC registration, but to excuse them from the recordkeeping rule to the extent that those records are incomplete or otherwise do not meet the requirements of Rule 204-2. Once a hedge fund adviser has registered with the SEC, however, it must comply with Rule 204-2 requirements on a going forward basis.

Rule 204-2: The SEC is also proposing an amendment to Rule 204-2 clarifying that, for purposes of Section 204 of the Act, the books and records of a hedge fund adviser registered with the SEC include records of the private funds for which the adviser acts as general partner, managing member, or in a similar capacity. The SEC is proposing this because it believes that in order to determine whether a hedge fund adviser is meeting its fiduciary obligations to a private fund under the Act, SEC examiners must have access to all records relating to the adviser's activities with respect to the fund, including records relating to the adviser's service as the fund's general partner because of its control over all of the operations and assets of the hedge fund. The SEC proposal would extend its access to private funds for which a related person of the adviser (as defined in Form ADV) acts as general partner, managing member, or in a similar capacity.

Rule 205-3: SEC advisers are only allowed to charge performance fees to certain "qualified clients."[3] The SEC is proposing to "grandfather" hedge fund advisers who charge performance fees from this requirement with respect to those persons who invest in the fund prior to the adviser's SEC registration in order to allow existing investors to retain (and add to) their existing investments in funds, even if they are not "qualified clients."

Rule 206(4)-2: SEC Rule 206(4)-2 requires advisers to pooled investment vehicles to deliver audited financial statements to investors within 120 days of the fund's fiscal year end. To accommodate advisers to funds of hedge funds, the SEC is proposing to extend the deadline for the delivery of audited financial statements to 180 days.

Form ADV: Form ADV will be amended to require specific information on hedge fund advisers.

Special Provisions for Funds of Hedge Funds

The new rule would also contain a special provision for advisers to hedge funds in which a registered investment company invests whereby such hedge fund would have to count each underlying investor of the investing registered investment fund as a client for purposes of the Rule.

Special Provisions for Offshore Advisers

The Rule would also require offshore fund advisers to look through the funds they manage, whether or not these funds are also located offshore, and count investors which are US residents as clients. The effect would be to treat offshore advisers of hedge funds the same as other advisers providing advice to US residents. The Rule, however, also provides an exemption to the definition of "private fund" for a company (1) whose principal office and place of business is outside the US, (2) that makes a public offering of its securities outside the US, and (3) that is regulated as a public investment company outside the US. Moreover, there is limited application of the Rule with regard to non-US clients of an offshore adviser.[4]

For example, offshore advisers required to register with the SEC would need to comply with rules regarding the safekeeping of client assets only with respect to assets of their U.S. clients. In addition, the SEC is proposing to permit an offshore adviser to an offshore fund to treat the fund as its client (and not the investors) for all purposes under the Act, other than (i) determining the availability of the Section 203(b)(3) private

adviser exemption, and (ii) those provisions prohibiting fraud. Such an adviser would be required to register with the SEC, but because the fund would not be a U.S. client, most of the substantive provisions of the Act would not apply to the adviser's dealings with the fund or its other non-U.S. clients.

The deadline for submitting comments is September 15, 2004. If you have a question regarding this alert or would like further information, please contact any member of the Investment Management Group listed below:

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Notes

1. Advisers with less than $25 million under management are not eligible for SEC registration but may be subject to state registration.
2. Under Rule 204-2 a registered investment adviser that makes claims concerning its performance "track record" must keep documentation supporting those performance claims. The supporting records must be retained for a period of five years after the performance information is last used. Thus, if a registered adviser promotes its 20-year performance record in 2004, it must continue to keep its supporting records for its 1984 performance through 2009 — five years after the last time that 1984 performance is included. SEC Release IA-2266, Section II.F.
3. Most hedge fund advisers charge a fee based on their fund's capital gains or appreciation, i.e., a "performance fee." Rule 205-3 permits registered investment advisers to charge performance fees only to "qualified clients," and requires the adviser to a fund to look through the fund to determine whether all investors are qualified clients. Generally, to be a qualified client of a registered investment adviser an investor must place at least $750,000 under that adviser's management or have a net worth of more than $1.5 million.
4. Nonetheless, with regard to assets held in pooled funds, including US clients' assets, the offshore adviser will be required to meet most of the requirements of the SEC rule on custody, 206-4(2), with respect to all assets of the pooled fund. SEC Release IA-2266, Section II.C.3.c.3.