

FUNDamentals™

Investment Management
Client Alert Series

Hedge Fund Adviser Registration

At the end of last week the U.S. Securities and Exchange Commission (the “SEC”) issued its adopting release for new Rule 203(b)(3)-2 and amended other rules that will now require advisers to certain private investment pools (commonly referred to as hedge funds) to register with the SEC under the Investment Advisers Act of 1940 (the “Advisers Act”).

Private Funds. New Rule 203(b)(3)-2 is designed to amend the method of counting that hedge fund advisers use for purposes of applying the private adviser exemption. Pursuant to the private adviser exemption contained in Section 203(b)(3) of the Advisers Act, any investment adviser who during the course of the preceding 12 months had fewer than 15 clients and who does not hold itself out generally to the public as an investment adviser is exempt from registration. Further, an adviser who provided advice to an organization was generally permitted to treat the organization as one client, pursuant to Rule 203(b)(3)-1, for purposes of the private adviser exemption.

Under the new rule, however, investment advisers are required to “look through” and count each owner (shareholder, limited partner, member or beneficiary, subject to certain exceptions) of a “private fund” towards the threshold of fewer than 15 clients for purposes of determining the availability of the private adviser exemption. A private investment company is a “private fund” if it meets three conditions: (1) the company is exempt from registration as an investment company under the Investment Company Act of 1940 pursuant to Section 3(c)(1) or Section 3(c)(7); (2) the company permits its investors to redeem their interest in the fund within two years of the purchase of such interest, other than in extraordinary circumstances; and (3) interests in the company have been offered based on the investment advisory skills or expertise of the investment adviser to the company.

As a result, an adviser to such a “private fund” can no longer rely on the private adviser exemption if the adviser, during the course of

the preceding twelve months, has advised private funds that had 15 or more investors. 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. If the total number of individual clients and investors in private funds total 15 or more, the adviser is not eligible for the private adviser exemption. If such an adviser is eligible for registration with the SEC (*i.e.* has more than \$25 million under management or is otherwise permitted to register with the SEC), the adviser must register with the SEC.

Offshore Advisers. For purposes of eligibility for the private adviser exemption, an offshore private 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. Again, an offshore adviser to any private fund that, in the course of the preceding twelve months, has 15 or more investors (or other advisory clients) that are U.S. residents generally must register under the Advisers Act. In the case of offshore advisers, however, this registration requirement applies without regard to the amount of assets under management, though certain regulatory requirements applicable to onshore advisers may not apply.

RELATED AMENDMENTS

Rule 204-2 (Recordkeeping Rule). The SEC adopted two amendments to the recordkeeping rule. The first amendment permits private fund advisers that are required to register with the SEC to market their performance from periods prior to their registration, even if they have not kept documentation that the rules would otherwise require. The second amendment to the recordkeeping rule clarifies, that, for purposes of Section 204 of the Advisers Act, the books and records of a registered private fund adviser include records of the private funds for which the adviser acts as an investment adviser and the adviser or a related person acts a general partner, managing member, or in a similar capacity.

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Rule 205-3 (Performance Fee Rule). In order to avoid disruption of existing arrangements between newly-registered private fund advisers and their current pool investors or separate account clients, the SEC amended Rule 205-3. Prior to the amendment, Rule 205-3 generally only permitted registered investment advisers to charge performance fees to “qualified clients” and to funds whose investors were “qualified clients.” The amendment grandfathers the existing equity accounts of private fund investors, and allows investors to add to their accounts. Advisers that must register as a result of being an adviser to a private fund may also continue to charge performance based fees to non-qualified clients (outside of the private fund) who were clients prior to February 10, 2005.

Rule 206(4)-2 (Adviser Custody Rule). The SEC amended the custody rule to allow additional time for completion of audit work on behalf of advisers to funds of private funds that choose to distribute audited fund financial statements to investors as a method of meeting the custody rule requirements. The amendment extends from 120 to 180 days the time within which an adviser to a fund of funds may distribute the fund’s audited financial statements. To be eligible for the extension, however, a fund of funds must invest at least 10 percent of its assets in other, unrelated, pooled investment vehicles.

Rule 222-2 and Rule 203A-3 (Counting Clients for Other Purposes). Rule 222-2 and Rule 203A-3 were amended to clarify that advisers and supervised persons may, for purposes of those rules (i.e. counting clients for purposes of applying the national “de minimis” standard for state adviser registration and for investment adviser representative registration), continue to count clients as provided in rule 203(b)(3)-1 without regard to the “look through” requirements in the new rule.

Form ADV. Form ADV was amended to require advisers to private funds to identify themselves as private fund advisers.

Effective and Compliance Dates. Amended Rule 206(4)-2 and the Form ADV amendments become effective January 10, 2005. Rule 203(b)(3)-2 and the other amended rules will become effective February 10, 2005. The

required compliance date for the new and amended rules, and the date by which hedge fund advisers will be required to register under the new rule, is February 1, 2006. It should be noted that the IARD will not be updated until March 8, 2005. The adopting release suggests incorporating amended responses with an adviser’s annual updating amendment. This would impact currently registered advisers with currently exempt hedge funds and their affiliates.

ACTION STEPS

Investment advisers that will be required to be registered under the new Rule should do the following prior to the February 1, 2006 compliance date for the new rule and the other amendments discussed above:

- ◆ Prepare Form ADV and revise client disclosures;
- ◆ Adopt and implement compliance policies and procedures;
- ◆ Adopt a code of ethics;
- ◆ Appoint a chief compliance officer;
- ◆ Prepare to maintain certain books and records;
- ◆ Review arrangements regarding custody of client assets and revise these arrangements as necessary;
- ◆ Prepare to obtain client consent for principal and agency transactions;
- ◆ Establish proxy voting policies and procedures;
- ◆ Establish procedures for advertising review;
- ◆ Review client contracts for compliance with the Advisers Act;
- ◆ Review soft dollar practices for compliance with requirements imposed on registered advisers;
- ◆ Review arrangements pursuant to which new clients and investors are generated, for compliance with the cash solicitation rule; and
- ◆ Prepare a business continuity plan.

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