

## Client Alert

# SEC Releases Final Rules Mandating Registration of Hedge Fund Advisers Under Investment Advisers Act

On December 2, 2004, the SEC released the final text of changes to the rules under the Investment Advisers Act of 1940, as amended, that will require advisers to hedge funds to register as investment advisers under the Advisers Act<sup>1</sup>. The SEC Commissioners approved the proposal by a 3 to 2 vote on October 26, 2004. The final rules are substantially similar to the rules proposed in July 2004. Advisers to hedge funds that are required to register under the amended rules must be registered by February 1, 2006.

The new registration requirement is intended to apply to hedge funds but not to funds that make long-term investments in illiquid securities such as private equity funds and venture capital funds. The SEC attempts to make this distinction on the basis of permissive redemption by investors. The new registration requirements would apply only to advisers to funds that permit investors to redeem their investments within two years of making the investment, except that an adviser to a fund that permitted redemptions in connection with an extraordinary event or of securities acquired with reinvested distributions of capital gains or income would not be subject to the registration requirement.

### Private Adviser Exemption

The Advisers Act generally requires investment advisers to register with the SEC, subject to an exclusion for advisers that are subject to a state investment adviser registration requirement and have less than \$25 million of assets under management. The Advisers Act defines an “investment adviser” as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities ....”

The general partners and investment advisers to many hedge funds have been relying upon the so-called “private adviser” exemption from registration found in Section 203(b)(3) of the Advisers Act. This exemption is available to a person who otherwise meets the definition of “investment adviser” but “who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under [the Investment Company Act of 1940, as amended], or a company which has elected to be a business development company pursuant to Section 54 of [the Investment Company Act] and has not withdrawn its election.”

---

<sup>1</sup> Securities and Exchange Commission Release No. IA-2333; File No. S7-30-04. A Copy of the Release is available on the SEC website at [www.sec.gov/rule/final/ia-2333.htm](http://www.sec.gov/rule/final/ia-2333.htm).

Under Advisers Act Rule 203(b)(3)-1 as in effect prior to the recent amendments, an investment adviser was permitted to count as a single client a “company” (which term includes a corporation, general partnership, limited partnership, limited liability company, trust or other legal organization) that received investment advice based on its investment objectives rather than the individual investment objectives of its owners. Thus, a general partner or investment adviser to hedge funds could advise up to 14 hedge funds without having to register under the Advisers Act.

### Changes to Rule Defining “Client”

The principal rule change adopted by the SEC was to amend Advisers Act Rule 203(b)(3)-1 so that a “private fund,” as defined in amended Rule 203(b)(3)-1, cannot be counted as a single client.

New Rule 203(b)(3)-2 requires investment advisers to look through a “private fund” and count each owner of the “private fund” as a client for purposes of determining the availability of the private adviser exemption of Section 203(b)(3) of the Advisers Act. As a result, an adviser to a “private fund” can no longer rely on the private adviser exemption if the adviser, during the course of the preceding 12 months, advised one or more private funds that had in the aggregate more than 14 investors. The new rule contains a special provision for advisers to hedge funds in which a registered investment company invests. Advisers to these hedge funds would be required to count the investors in the registered fund as clients. The rule, as adopted, permits an adviser to exclude itself and certain knowledgeable employees. The SEC’s Release accompanying the final rule amendments states that an adviser to a fund in which a “fund of hedge funds” invests will have to look through the “fund of hedge funds” and count the investors in the “fund of hedge funds” as clients of the adviser.

Amended Rule 203(b)(3)-1 defines a “private fund” as a company having the following characteristics:

- the company would be subject to regulation under the Investment Company Act but for the exception provided in either Investment Company Act Section 3(c)(1) (which excludes from the definition of an investment company a company that has not made and does not propose to make a public offering of its securities and the securities of which are owned by 100 or fewer beneficial owners) or Section 3(c)(7) (which excludes from the definition of an investment company a company that has not made and does not propose to make a public offering of its securities and the securities of which are owned exclusively by “qualified purchasers”);
- the company permits investors to redeem their interests (i.e., sell them back to the company) within two years of purchasing them, excluding redemptions in the case of events that the adviser finds after reasonable inquiry to be extraordinary and redemptions of securities acquired through reinvestment of distributed capital gains or income; and
- interests in the company are or have been offered based upon the investment advisory skills, ability or expertise of the investment adviser.

The first characteristic applies equally to hedge funds, on the one hand, and private equity funds and venture capital funds, on the other hand. The second characteristic is, in the SEC’s view, the characteristic that distinguishes hedge funds from these other types of funds. The third characteristic is based on the SEC’s view that hedge fund investors rely on the adviser’s history,

experience, strategies and disciplinary record and thus this reliance implicates the need for the Advisers Act protections.

### Offshore Advisers

A hedge fund adviser with its principal office and place of business outside the United States will be required to count only clients who are U.S. residents. (The SEC staff has traditionally required U.S.-based advisers to count non-resident clients as well as resident clients.) These offshore advisers will be required to look through the funds they manage, whether or not those funds are also located offshore, and count investors who are U.S. residents as clients. An offshore adviser to any hedge fund that, in the course of the previous 12 months, has more than 14 investors who are U.S. residents, would generally have to register under the Advisers Act. Under the amended rules, an offshore adviser may determine whether an investor in a private fund is a U.S. resident at the time of investment and would not be required to reclassify non-residents who later move to the United States. In addition to U.S. resident investors in hedge funds managed by an offshore adviser, the offshore adviser would also have to count other advisory clients who are U.S. residents in determining the availability of the private adviser exemption.

In order to prevent advisers to offshore publicly offered mutual funds or closed-end funds from having to register with the SEC simply because the funds have more than 14 investors who are resident in the United States, the amended rules include an exception to the definition of “private fund” for a company that “has its principal office and place of business outside the United States, makes a public offering of its securities in a country outside the United States, and is regulated as a public investment company under the laws of the country other than the United States.” The SEC’s Release accompanying the final rule amendments makes clear that an offshore fund has to be authorized for sale to the public in the jurisdiction in which it is regulated as an investment company to qualify for this exception.

The final rule amendments limit the extraterritorial application of the Advisers Act that would otherwise occur as a result of the amendments. In the past, the SEC staff has advised a number of offshore advisers in “No-Action Letters” (informal staff advice in which the SEC staff states that it would not recommend enforcement action to the SEC if the party requesting the advice engages in specified conduct) that they are not required to apply most of the substantive provisions of the Advisers Act to their non-U.S. clients. The SEC’s release stated that this treatment will be extended to offshore funds advised by offshore advisers. The amended rules permit an offshore adviser to an offshore fund to treat the fund as its client (and not the investors) for all purposes under the Advisers Act, other than (i) determining the availability of the private adviser exemption (Section 203), (ii) certain of the requirements to maintain books and records (Section 204), and (iii) those provisions prohibiting fraud (Sections 206(1) and 206(2)). For example, offshore advisers registered with the SEC would be required to comply with the Advisers Act rules regarding the custody of client assets only with respect to assets of their U.S. clients. Absent this relief, the Advisers Act custody rule would, as a practical matter, require the adviser to meet many of the requirements of the rule with respect to all assets of an offshore fund even if most of the fund investors are not U.S. residents.

### Other Rule Changes

The SEC also amended a number of rules in order to ease the transition of hedge fund advisers into the regulated investment adviser environment. For example, the SEC amended the Advisers Act rule limiting the imposition of performance fees so that it will not apply to the adviser to a private fund with respect to investors in private funds and other clients whose investment was made or whose advisory relationship began prior to February 10, 2005. In addition, an adviser will obtain limited relief from the requirement that it maintain records to substantiate its performance claims with respect to records relating to periods prior to its registration under the Advisers Act.

### Effective and Compliance Dates

The effective date of most of the amendments adopted by the SEC is February 10, 2005. Hedge fund advisers required to register under the Advisers Act as a result of these rule changes have until February 1, 2006 to register. By February 1, 2006, each adviser required to register under the amended rules must have its registration effective, and must comply with the substantive requirements of the Advisers Act and the SEC's rules.

\* \* \* \* \*

December 14, 2004

For Additional Information

This client alert can be found, together with other recent Chadbourne & Parke LLP client alerts, on our website at [www.chadbourne.com/publications/sub\\_Publications.html](http://www.chadbourne.com/publications/sub_Publications.html). Our client alerts are for general informational purposes and should not be regarded as legal advice. If you have any questions regarding the SEC's amended rules with respect to registration of hedge fund advisers, please contact any of the following:

New York

Marc A. Alpert	+1 (212) 408-5491	malpert@chadbourne.com
Philip L. Colbran	+1 (212) 408-1122	pcolbran@chadbourne.com
A. Robert Colby	+1 (212) 408-5571	rcolby@chadbourne.com
Dennis R. Dumas	+1 (212) 408-1184	ddumas@chadbourne.com
Barry S. Eisler	+1 (212) 408-1073	beisler@chadbourne.com
William Greason	+1 (212) 408-5527	wgreason@chadbourne.com
Morton E. Grosz	+1 (212) 408-5592	mgrosz@chadbourne.com
Charles E. Hord, III	+1 (212) 408-5353	chord@chadbourne.com
Peter K. Ingerman	+1 (212) 408-5422	pingerman@chadbourne.com
Peter R. Kolyer	+1 (212) 408-5564	pkolyer@chadbourne.com
Clara Krivoy	+1 (212) 408-1104	ckrivoy@chadbourne.com
Sey-Hyo Lee	+1 (212) 408-5122	shlee@chadbourne.com
Thomas C. Meriam	+1 (212) 408-5355	tmeriam@chadbourne.com
J. Allen Miller	+1 (212) 408-5454	amiller@chadbourne.com
John G. Moon	+1 (212) 408-1117	jmoon@chadbourne.com
Talbert I. Navia	+1 (212) 408-5316	tnavia@chadbourne.com
Sheila M. Peluso	+1 (212) 408-5358	speluso@chadbourne.com
Bruce J. Rader	+1 (212) 408-5449	brader@chadbourne.com
Edward P. Smith	+1 (212) 408-5371	esmith@chadbourne.com
Kevin C. Smith	+1 (212) 408-1092	ksmith@chadbourne.com

Washington, D.C.

Joaquin M. Sena	+1 (202) 974-5775	jsena@chadbourne.com
Thomas V. Sjoblom	+1 (202) 974-5636	tsjoblom@chadbourne.com

London

David Levin	+44 (20) 7337-8048	dlevin@chadbourne.com
Claude S. Serfilippi	+44 (20) 7337-8030	cserfilippi@chadbourne.com