

## Client Alert

# SEC Proposes Mandatory Registration of Hedge Fund Advisers Under Investment Advisers Act

On July 14, 2004, the SEC proposed changes to the rules under the Investment Advisers Act of 1940, as amended, that would 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, which was unusual for its lack of consensus.

The SEC's proposal is intended to apply to hedge funds but not to private equity funds and venture capital funds that make long-term investments in illiquid securities. 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.

The public comment period on the SEC's proposal will expire on September 15, 2004. The SEC staff has said that they expect final action on the proposal by the end of the year.

### Current Rules

The Advisers Act generally requires investment advisers to register with the SEC, subject to an exclusion for advisers required to register with a state that 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has elected to be a business development company pursuant to section 54 of [the Investment Company Act] and has not withdrawn its election." Under current Advisers Act Rule 203(b)(3)-1, an investment adviser is permitted to count as a single client a corporation, general partnership, limited partnership, limited liability company, trust or other legal organization that receives investment advice based on its investment objectives rather than the

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<sup>1</sup> Securities and Exchange Commission Release No. IA-2266; File No. S7-30-04. A Copy of the Release is available on the SEC website at [www.sec.gov/rule/proposed/ia-2266.htm](http://www.sec.gov/rule/proposed/ia-2266.htm).

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.

Registration under the Advisers Act is accomplished through filing of a Form ADV with the SEC. Part I of Form ADV requires advisers to answer basic questions about their business, their affiliates and their owners. Advisers must also complete Part II of Form ADV and deliver a copy of Part II or a disclosure brochure containing the same information to clients. Part II requires disclosure of the types of advisory services the adviser offers and the fees the adviser charges for those services, the types of clients the adviser services, the types of investments for which the adviser provides advice, the methods of analysis and the sources of information the adviser employs in giving investment advice, the education and background of the individuals responsible for providing investment advice, other business activities of the adviser and certain conflicts of interest.

Registration under the Advisers Act will subject an investment adviser to a number of rules regulating its business practices. Registered advisers are required to comply with rules under the Advisers Act relating to maintenance of specified books and records, custody of client assets, proxy voting, development of compliance procedures and designation of a chief compliance officer, and adoption of a code of ethics and policies and procedures to prevent the misuse of confidential information. A registered adviser would also be subject to periodic examination by the staff of the SEC. The Advisers Act and the rules under the Advisers Act also prohibit certain actions deemed fraudulent.

### Changes to Rule Defining "Client"

The principal rule change proposed by the SEC involves Advisers Act Rule 203(b)(3)-1, which currently permits the general partner and investment adviser to a hedge fund to count the hedge fund as a single client. The SEC's proposal would amend this Rule so that a "private fund," as defined in proposed Rule 203(b)(3)-2, could not be counted as a single client.

Proposed Rule 203(b)(3)-2 would require 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" could 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 proposed 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 proposed rule would define 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 in the fund (i.e., sell them back to the fund) within two years of purchasing them, except for redemptions in

the case of events that were extraordinary and unforeseeable at the time of issuance of the interest and except for redemptions of securities acquired through reinvestment of dividends; and

- interests in a private fund are or have been offered based 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 SEC cited as examples of redemptions in the case of events that were extraordinary and unforeseeable redemptions upon the death or total disability of an interest owner or in circumstances that make it illegal or impractical for an investor to continue to own an interest in the fund. 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 would be required to count only clients who are U.S. residents. These advisers would be required to look through the funds they manage, whether or not those funds are also located offshore, and count investors that 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 (or other advisory clients) that are U.S. residents would generally have to register under the Advisers Act.

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 fourteen investors who are resident in the United States, the proposed rule includes 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 also proposed to limit the extraterritorial application of the Advisers Act that would otherwise occur as a result of these 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 the SEC intended to extend this treatment to offshore funds. The proposed rule would 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(b)(3)), and (ii) those provisions prohibiting fraud (Sections 206(1) and 206(2)). For example, offshore advisers registered with the SEC would be required to comply with 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 proposed to amend a number of rules in order to ease the transition of hedge fund advisers into the regulated investment adviser environment. For example, the SEC has proposed that the Advisers Act rule limiting the imposition of performance fees would not apply to the adviser to a private fund with respect to investors whose investment predated the effective date of the new rules. In addition, an adviser would 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.

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For Additional Information

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