

Client
Advisory

SEC Proposes Rule Regarding the Registration of Certain Hedge Fund Advisers

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In response to the rapid growth of hedge funds and related fraud cases, and what has been dubbed the “retailization” of hedge funds, the SEC, after a 3-2 vote, recently released for comment a proposed new rule and rule amendments under the Investment Advisers Act of 1940 which, if adopted, would effectively require certain hedge fund and other unregistered investment advisers to register with the SEC.

Currently, under the so-called “private adviser exemption,” an investment adviser is exempt from registration with the SEC if it:

- has had fewer than 15 clients during the preceding 12 months;
- does not hold itself out generally to the public as an investment adviser; and
- is not an adviser to any registered investment company.

Under current rules, investment advisers are permitted to count private investment companies, commonly known as “hedge funds,” as one client for purposes of determining whether they have exceeded the 15-client threshold (the “threshold”). The proposed rule, if adopted, would require an investment adviser to “look through” to and count each investor in a “private fund” as a client for purposes of the threshold and other requirements of the Advisers Act. In addition, if the investor in the private fund is a registered investment company (*i.e.*, a mutual fund), the adviser would be required to further look through to and count each investor in such registered fund as a client.

A “private fund,” which is intended to bear the same characteristics as a traditional hedge fund, would be defined as a company:

- that would be an “investment company” under the Investment Company Act of 1940 but for the exception provided by either section 3(c)(1) (a “3(c)(1) fund”) or section 3(c)(7) (a “3(c)(7) fund”) thereof;
- that permits its investors to redeem any portion of their investment within two years of the purchase thereof; and
- interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.

A private fund would not include a company that:

- has its principal office and place of business outside of the U.S. (*i.e.*, “offshore”);
- has made a public offering of its securities offshore; and
- is regulated as a public investment company offshore.

This exemption would permit an adviser to count an offshore public fund (regardless of the number of investors therein) as one client for purposes of the threshold and other requirements under the Advisers Act. On the other hand, an adviser would still be required to count each U.S. investor in an offshore private fund as a client for purposes of the threshold. If such an adviser is located offshore, however, then most of the other substantive provisions of the Advisers Act (other than the antifraud provisions) would not apply to its dealings with offshore private funds and any offshore clients.

If required to register under the new rules, certain hedge fund and other unregistered investment advisers would become subject to SEC oversight and examination, and be required to comply with all of the provisions of the Advisers Act and rules promulgated thereunder.¹ As a result, these advisers would be required to, among other things:

- file with the SEC and periodically update Form ADV;
- maintain certain business records;
- adopt and implement compliance programs; and
- adopt and implement a codes of ethics (effective August 31, 2004).

In addition to the new rules described above, the SEC also proposed amendments to rules under the Advisers Act to accommodate certain pre-existing arrangements and practices involving unregistered advisers that would otherwise violate the Advisers Act. For example, the Adviser’s Act requires registered advisers to retain records supporting performance information for at least five years after last use. Since some hedge fund advisers may not have retained these records (because they were not required to do so), they will only be required to retain whatever records they currently have. Going forward, however, such advisers would be required to comply with all of the Advisers Act’s recordkeeping rules.

Another example relates to performance fees. Registered investment advisers generally may only charge performance fees to 3(c)(1) funds whose investors are “qualified” clients² and to 3(c)(7) funds. Unregistered advisers to 3(c)(1) funds that have been charging performance fees to existing

¹ Note that unregistered investment advisers have always been subject to the Advisers Act’s antifraud provisions.

² “Qualified” clients have a net worth in excess of \$1.5 million or at least \$750,000 invested with the adviser.

clients that are not qualified would be permitted to continue do so with respect to those clients even after registering with the SEC. However, the Advisers Act's conditions and restrictions on performance fees would apply to any new clients of the adviser.

Finally, under the Advisers Act's custody rules, registered investment advisers are generally deemed to have custody of the assets of the funds that they advise and, thus, have an obligation to deliver custody account information to investors in the fund. Registered advisers may currently satisfy this obligation by distributing the fund's audited financial statements to investors within 120 days after the fund's fiscal year end. As one would expect, advisers to funds of funds would need to wait for the underlying funds to provide the audited financial statements before they can distribute such information to their own investors. The proposed amendments attempt to make it easier for such advisers to comply with these rules by extending the deadline from 120 days to 180 days after the funds' fiscal year end.

Overall, the proposal, if adopted, would not require SEC registration of small unregistered investment advisers, such as those with less than \$25 million in assets under management³ or fewer than 15 investors. Furthermore, most private equity, venture capital, mezzanine capital and other capital commitment funds should remain unaffected.

Comments on the proposal are due on or before September 15, 2004 and may be viewed on the SEC's website located at <http://www.sec.gov/rules/proposed.shtml>. The SEC expects to adopt and issue the final rule and rule amendments by the end of this year.

Questions

We welcome your questions and comments. If you have any questions or would like more information about the contents of this Advisory, please call any of the following attorneys at Kelley Drye & Warren LLP:

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³ These advisers are currently prohibited from registering with the SEC unless they advise a registered investment company or otherwise qualify for registration. These advisers may, however, be required to register with the regulator in any state in which it does business (*i.e.*, has an office or clients).