

The SEC Proposal to Register Hedge Fund Advisers

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The US Securities and Exchange Commission (SEC) has issued its anticipated proposal to require 'hedge fund' advisers to register as investment advisers. The proposal would require hedge fund advisers with more than 14 investors and \$30 million under management to register; smaller advisers would be potentially subject to state registration requirements. The proposal is intended to exclude from the registration requirement advisers to private equity and venture capital funds, by excluding funds that do not provide redemption rights within two years following an investment. In addition, advisers to non-US mutual funds are generally excluded, regardless of the jurisdiction in which the adviser is located. Special rules apply to non-US advisers, which would be permitted to avoid many of the requirements of SEC registration if their only US clients are investors in offshore funds. The proposal also includes provisions designed to facilitate the transition to registration if the proposal is adopted, by extending the deadline under the custody rule for registered advisers electing to provide a fund's audited financial statements to investors. Finally, the proposal includes several changes to Form ADV. While the proposal has generated significant policy debate, this article focuses on the provisions of the proposal itself.

Overview

Many hedge fund advisers avoid registration under the Investment Advisers Act of 1940 (Advisers Act) by relying upon the 'private adviser' exemption contained in Section 203(b)(3) of the Advisers Act. Under this section, an investment adviser is not required to register with the Securities and Exchange Commission if it has had fewer than 15 clients during the preceding 12 months and neither holds itself out to the public as an investment adviser nor acts as the investment adviser to a mutual fund registered with the SEC under the Investment Company Act of 1940 (Investment Company Act). A hedge fund has historically been counted as one client for these purposes.

Current Rule 203(b)(3)-1 under the Advisers Act provides, for the purpose of Section 203(b)(3), that an entity that receives investment advice based on its collective objectives rather than those of the individual investors is treated as a single client.¹ As a result, investment advisers that advise hedge funds are currently able to treat each fund managed as a single client, which effectively enables hedge fund managers to avoid SEC registration, if they confine their activities to advising hedge funds.

On 14 July 2004, the SEC proposed to amend Rule 203(b)(3)-1 and adopt a new rule 203(b)(3)-2 under the Advisers Act, along with certain other revisions (collectively the Rule Proposal) that would require an investment adviser to 'look through' certain funds to count the number of clients for purposes of the 'private adviser' exemption.² Certain US investment advisers not registered with the SEC who rely on Section 222 of the Advisers Act and Rule 222-2 thereunder to avoid registration with the States (the 'blue sky pre-emption') may also have to look through certain funds to count the number of clients they have in a State for purposes of determining whether they are eligible for the blue sky pre-emption.³

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The rule proposal also includes several related changes to existing SEC requirements for investment advisers that are intended to alleviate the transition to registration for advisers with respect to recordkeeping and charging performance fees. The rule proposal provides relief to unregistered fund of funds managers under the custody rule by permitting audited financial statements to be provided to investors within 180 days rather than the current 120 days. Finally, the rule proposal includes certain revisions to Form ADV that would require additional information with respect to private funds managed by an investment adviser.

The Rule Proposal follows a report on the 'Implications of the Growth of Hedge Funds' (the Staff Hedge Fund Report) released last fall by the SEC staff.⁴ In the Staff Hedge Fund Report, the staff outlined the nature of the hedge fund industry, the current regulatory framework that applies to hedge funds, the staff's concerns with hedge fund practices, and recommendations to the SEC for modifying the regulation of hedge funds and hedge fund managers. The Staff Hedge Fund Report stressed that one of the staff's greatest areas of concern is the SEC's limited ability to obtain comprehensive and reliable information about hedge funds absent mandatory registration of their advisers. The staff recommended, among other things, requiring hedge fund managers, both domestic and offshore, to register as investment advisers under the Advisers Act.

Specific Provisions of the Rule Proposal

Amendment of the 14 Client Exemption for Private Fund Managers

Currently, Rule 203(b)(3)-1(a)(2) permits an investment adviser to consider as a single client, 'a corporation, general partnership, limited partnership, limited liability company, trust..., or other legal organisation' to which investment advice is provided based on the organisation's investment objectives rather than the individual investment objectives of an underlying investor. The Rule Proposal would explicitly exclude 'private funds' as defined thereunder from being able to rely on the Rule 203(b)(3)-1 safe harbour. With respect to advisers to hedge funds in which a registered investment company invests, the Rule Proposal would require the adviser to look through the hedge fund investor (the registered fund) and count each shareholder in the registered investment company as an individual client.

Under the Rule Proposal, an investment adviser whose principal office and place of business is in the United States would need to count each investor in the 'private fund' as a client for the purpose of determining whether an adviser is exempt from registration under Section 203(b)(3). However, the Rule Proposal would require that an investment adviser whose principal office and place of business is located outside the United States only count investors in the private fund that are US residents for the purpose of determining eligibility under the exemption. (There is no definition of the term 'US resident' in the Proposing Release but the SEC staff generally considers that the term US resident has a meaning similar to that of 'US Person' as defined in Regulation S under the Securities Act of 1933.⁵) Similarly, the Rule Proposal would permit such an offshore adviser to treat an offshore private fund as its client (and not the investors) for all purposes under the Advisers Act other than determining the availability of the private adviser exemption and the antifraud provisions of the Advisers Act, Sections 206(1) and 206(2). Moreover, because such an offshore fund would not be a US client of the offshore adviser, under current SEC staff guidance, the Advisers Act's substantive provisions generally would not apply to the adviser's dealing with the fund, although the offshore adviser, among other things, would have to comply with the Advisers Act's recordkeeping requirements with respect to the fund and its other clients and would have to undertake to promptly provide such records to the SEC upon request and make its personnel available for testimony before, or questioning by, the SEC or its staff.⁶

Definition of Private Fund

Under the Rule Proposal, Rule 203(b)(3)-2(d)(1) would define 'private fund' as a company that would be an investment company under section 3(a) of the Investment Company Act, but for the exceptions provided in sections 3(c)(1) or 3(c)(7) of the Investment Company Act⁷ and that permits owners to redeem any portion of their ownership interests within two years and which offers interests based on the investment advisory skills, ability or expertise of the investment adviser.

However, the Rule Proposal would exclude from the definition of 'private funds' a company that permits its owners to redeem their ownership interests within two years in the case of:

- events found after reasonable inquiry to be extraordinary and unforeseeable at the time of issuance; and

- interests acquired with reinvested dividends.

The two-year lock-up requirement is designed to exclude private equity and venture capital funds but does not depend upon the nature of the fund beyond the lock-up provision.

The definition excludes companies with a principal office and place of business outside the United States that make a public offering of their securities outside the United States and are regulated as a public investment company under the laws of another country. This provision is intended to exclude non-US mutual funds. However, it likewise does not depend upon the nature of the fund beyond the determination by any non-US government to permit its public offering and regulate it as a fund.

Change to Recordkeeping Requirements

The Rule Proposal would amend current recordkeeping requirements under Rule 204-2(e)(3)(ii), to permit advisers that are subject to the Advisers Act registration requirements for the first time as a result of the Rule Proposal, to utilize performance information for periods that predate the adviser's registration without having the records for the period of time that would otherwise be required to support the performance claims. The Rule Proposal also explicitly provides that books and records of a private fund managed by an adviser shall be deemed to be the records of the adviser for purposes of Section 204 of the Advisers Act.

Change to Performance Fee Rules

The Rule Proposal includes a new section in Rule 205-3, that permits advisers that were previously exempt from registration before enactment of the Rule Proposal to charge performance fees to current clients in existing funds, notwithstanding the prohibitions of Rule 205-3(b), which places limitations on the ability of managers to charge performance fees.

Change to Custody Rules

Under the Rule Proposal, Rule 206(4)-2(b)(3) would be amended to permit a pooled vehicle to provide its audited financial statements to investors in lieu of a quarterly account statement within 180 days (rather than 120 days) of the end of its fiscal year. Although this change is intended to provide relief to funds of funds, the longer time period would be available to all hedge funds. The SEC indicated in the Proposing Release that, until it takes action on this portion of the Rule Proposal, the SEC's Division of Investment Management will not recommend any

enforcement action against an investment adviser to a fund of funds that acts in accordance with the proposed amendment.

Changes to Form ADV

The Rule Proposal would require that Form ADV contain a new Item 7 that requires the Adviser to disclose if it is a general partner or manager or adviser to a private fund and, if so, the adviser must provide information in Schedule D regarding private funds advised by the adviser as well as a listing of all funds in Item 7(b) and certain other information regarding investors in the private funds.

The SEC is accepting comments on the proposal until 15 September 2004.

Endnotes:

1. Rule 203(b)(3)-1 indicates that an investment adviser whose principal office and place of business is in the United States must count each such investor as a client, but that an investment adviser whose principal office and place of business is located outside the United States must only count US persons as clients for the purpose of determining eligibility under the exemption.
2. *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Rel. No. IA-2266 (20 July 2004) [hereinafter 'Proposing Release'] available at <http://www.sec.gov/rules/proposed/ia-2266.htm>.
3. Advisers not registered with the SEC generally may be required to register by the States where they do business. Section 222, however, provides, among other things, that no US State may require an investment adviser to register with the State if the adviser has no place of business located within the State and has had fewer than six clients who are resident of that State in a 12-month period. Rule 222-2 provides that for purposes of this part of Section 222, an investment adviser may rely upon the definition of 'client' provided by Rule 203(b)(3)-1. Thus, as a consequence of the Rule Proposal, an unregistered investment adviser to certain funds may have to look-through the funds to count clients and may have to register with a State if there are more than five investors in the funds who are resident of the State.

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4. *Implications of the Growth of Hedge Funds*, Staff Report to the SEC, (September 2003), available at <http://www.sec.gov/news/studies/hedgelfunds0903.pdf>.
5. See *Murray Johnstone Holdings Ltd.*, SEC No-Action Letter (pub. avail. 7 October 1994).
6. See, eg, *Uniao de Bancos de Brasileiros S.A.*, SEC No-Action Letter (pub. avail. 28 July 1992).
7. Hedge funds generally are structured to come under the 'private' investment company exceptions from the definition of investment company found in Section 3(c)(1) and 3(c)(7) of the Investment Company Act in order to avoid registration and regulation thereunder. In order to satisfy Section 3(c)(1) and 3(c)(7), the hedge fund entity must not conduct a public offering of its shares and generally must, for 3(c)(1) purposes, limit its number of investors to less than 100 persons, and, for 3(c)(7) purposes, its investors must be limited to persons who are 'qualifying purchasers'. Offshore funds may generally apply the counting or qualification requirements just to their US investors and limit the private offering requirement to their US offering.

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