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A legal update from Dechert's Financial Services Group

Client Alert: The SEC Adopted Rules To Register Hedge Fund Advisers

At an open meeting on October 26, 2004, the U.S. Securities and Exchange Commission ("SEC") met and adopted a new Rule 203(b)(3)-2 and amendments to Rule 203(b)(3)-1 under the Investment Advisers Act of 1940 ("Advisers Act") that require many hedge fund managers, both in the U.S. and abroad, to register as investment advisers with the SEC. The rules will be effective in February 2006.

Under amended Rule 203(b)(3)-1 and new Rule 203(b)(3)-2, investment advisers to a "private fund" will be required to "look through" the fund to count the number of clients of the investment adviser. A "private fund" would be defined as a fund that: is not required to be registered and regulated as an investment company under the Investment Company Act of 1940 because of an exception from the definition of "investment company" under Section 3(c)(1) or 3(c)(7); permits an investor to redeem its investment within two years (thus, exempting from the definition of "private fund" a number of funds known as "private equity" or "venture capital" funds); and is offered based on its adviser's expertise. The new rules will require persons or entities to register with the SEC if they act as investment adviser to a fund or funds that have 15 or more investors.¹ Non-

¹ Under Section 203 of the Advisers Act, an investment adviser is required to register with the SEC if the adviser has had 15 or more clients during the preceding 12 months or if it acts as the adviser or sub-adviser to a mutual fund registered with the SEC under the Investment Company Act of 1940. Rule 203(b)(3)-1 under the Advisers Act, prior to its amendment, stated for the purposes of Section 203 that an entity that receives investment advice based on its objectives rather than those of the individual investors should be treated as a single client and as a result, each hedge fund is currently treated as a single client.

U.S. investment advisers would only have to count their "U.S. clients."

While the text of the final rules and the related commentary has not yet been released, some general information was provided at the open meeting. The new rules were described as being substantially similar to the proposal except for certain changes made in response to comments received about it.² The compliance date for the new rules is February 2006.

The SEC staff indicated during the SEC meeting that:

- Under the new rules, non-U.S. investment advisers would be required to look at the place of residence of the hedge fund investors at the time of investment to determine whether they are "U.S. clients";³
- In order to calculate the amount of assets under management to determine whether an investment

² See *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Rel. No. IA-2266 (July 20, 2004) (the "proposal") available at <http://www.sec.gov/rules/proposed/ia-2266.htm>. For additional information regarding the proposal, see Dechert Financial Services: Legal Update Issue No. 22 (Aug. 2004), available at http://www.dechert.com/practiceareas/practiceareas.jsp?pg=legal_update&pa_id=19&pn=1.

³ The staff also indicated that the place of residence of a corporation generally is its place of organization and a trust is the place of residence of its trustee.

adviser is subject to federal registration under the new rules, the adviser would not be required to include proprietary assets of the investment adviser and its personnel;⁴

- A task force is being appointed to tailor the SEC staff inspection program to hedge fund managers;
- The SEC staff would be available to the hedge fund industry to respond to questions that may arise under the new rules; and
- In addition to those provided in the proposal, the new rules will have several transition provisions to facilitate the process of registering investment advisers to hedge funds, including prospective counting from the compliance date for determining if the adviser has more than 14 clients in a 12-month period.⁵

⁴ An investment adviser is eligible to register with the SEC under the Advisers Act when its has \$25 million or more under management and is required to register when its has more than \$30 million under management. Advisers with less assets under management may be subject to State registration.

⁵ For example, advisers that were previously exempt from registration will be able to charge performance fees to investors who were in their funds before the compliance date, regardless of whether those investors meet the requirements to be charged a performance fee by a registered adviser.

At the open meeting, echoing the July 14, 2004 meeting during which the SEC voted on the proposal, SEC Chairman Donaldson and the SEC staff emphasized the objectives of the new rules, including the need to provide the SEC with vital information about the hedge fund industry, make available additional information to investors, monitor the hedge fund industry because it is increasingly available to retail investors and deter violations of U.S. securities laws by hedge funds managers that, once registered, would have to adopt compliance programs. They insisted that the goal of the SEC and its staff is not to tamper with the operation of hedge funds, recognized the contribution of hedge funds to the U.S. economy and argued that ultimately, these new rules will strengthen the role of hedge funds. SEC Commissioners Atkins and Glassman spoke against the new rules. Approval of the new rules was not unanimous; two of the five SEC Commissioners voted against the proposal.

When the new rules are made available to the public, Dechert LLP will distribute a more detailed Client Memorandum.

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