

SEC Staff Issues Guidance on New Hedge Fund Adviser Registration Rule

On December 8, 2005, the Staff of the Division of Investment Management (the "Division") of the U.S. Securities and Exchange Commission (the "SEC") released guidance on the new hedge fund adviser registration rule in response to a request from the American Bar Association Subcommittee on Private Investment Entities (the "Subcommittee").¹

While the *ABA Letter* addresses many of the questions that unregistered advisers to private funds have been struggling with since the adoption of the requirements, two key issues raised in the *ABA Letter* are of critical, time-sensitive importance to advisers who are in the process of registering, as well as those who are planning to institute a "two-year lockup" in order to avoid the registration requirement.

First, the Division has clarified certain aspects of the so-called "two-year lockup exception" to the definition of private fund. Second, the Division has indicated that while the February 1, 2006 compliance date for registration remains effective, the Division Staff will seek to act quickly on Forms ADV filed by January 9, 2006, so they can be effective by the compliance date.

This update will examine these two issues, while the remaining matters will be addressed in another forthcoming update.

Two-Years (and a Day) Lockup

Amended Rule 203(b)(3)-1(d) generally defines a "private fund" as "a company ... (2) that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests" The Subcommittee sought confirmation from the Division that a fund which allowed its participants to redeem on the final day of the second year would not violate the "within two years" requirement to avoid being a "private fund."²

The industry felt that such an interpretation would be within the spirit of the two-year lockup without causing excessive tax and accounting difficulties. The Subcommittee noted that, as reflected on the books of the fund, funds typically accept new capital on the first day of the month, and redeem capital on the last day of the month. The Division disagreed with the view that such a fund would meet the two-year lockup requirement.

The Division instead took a strict approach, arguing that if an owner is permitted to redeem before the first day of the third year of the investment (the second anniversary of the investment), then under Rule 203(b)(3)-1(d), the owner is permitted to redeem his ownership interest "within two years of the purchase of such interest" and thus, the fund is a "private fund" under the rule. This means that, if an ownership interest is purchased on January 1, 2007, it could not be redeemed prior to January 1, 2009 (absent extraordinary circumstances), and still meet the two-year lockup requirement.

¹ Section 203(b)(3) of, and Rules 203(b)(3)-1 and 203(b)(3)-2 under, the Investment Advisers Act of 1940, as amended ("Advisers Act"). See Release No. IA-2333 (Dec. 2, 2004). See also *American Bar Association Subcommittee on Private Investment Entities* (pub. avail. Dec. 8, 2005) (the "ABA Letter"), available at <http://www.sec.gov/divisions/investment/noaction/aba120805.htm>. The Subcommittee's request letter is available at <http://www.sec.gov/divisions/investment/noaction/aba120805-incoming.pdf>.

² The Subcommittee posited the example of a purchase on January 1, 2007 and a redemption on December 31, 2008.

Advisers wishing to rely on the two-year lockup when taking new money should revise fund documents to be consistent with the Division's position.

Filing "Deadline" Extended; Registration "Deadline" Remains the Same

The Division confirmed February 1, 2006, as the compliance date by which advisers to "private funds" must have their SEC registration effective. The Division reminded advisers that Section 203(c)(2) of the Advisers Act provides that a registration shall be declared effective within 45 days after the adviser files its Form ADV (unless the SEC institutes proceedings to deny registration within that time period). The Division urged advisers required to register to submit their applications no later than December 15, 2005, to ensure compliance with the February 1, 2006 date, although December 16 is actually the final day a filing can be made for the full 45 days to run by February 1.³

The Subcommittee noted that the Division is often able to (and typically does) declare registrations effective in far less time than 45 days. The Division responded that if an adviser required to register as a result of the Commission's adoption of Rule 203(b)(3)-2 files its initial application for registration as an investment adviser on Form ADV with the SEC no later than January 9, 2006, the staff will *endeavor* to act upon the application by February 1, 2006 (emphasis added).

As the 45-day threshold approaches, advisers should seek to file at the earliest possible date. When possible, a complete and accurate filing should be made by December 15. However, if more time is needed, the Division's statement regarding the January 9 date should be helpful. It will be particularly important to ensure that any filing on the later date is complete in order to facilitate timely registration. Also, any adviser that must disclose adverse regulatory events should understand that accelerated registration may be more difficult to obtain.

In addition, the Division made a point to advise that, in order to ensure that new registrants' first annual updating amendment is due by March 31, 2007 (for a new registrant with a fiscal year ending December 31), rather than March 31, 2006, Form ADV filings made on or after November 20, 2005, will not be declared effective

before January 3, 2006, absent filer requests to the contrary.

Advisers should remember that all requirements of registration must be in place on the date registration is granted, including a complete Form ADV Part II and required policies and procedures. The Division has indicated that it intends to request copies of Form ADV Part II to evaluate the risk involved with advisers, and advisers should be prepared to respond to such a request as soon as they become registered.

As previously noted, Dechert LLP will distribute a more detailed update addressing the other important issues touched upon in the SEC's response letter.

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³ See Dechert OnPoint: *The SEC Adopted Rules to Register Hedge Fund Advisers* (Oct. 27, 2004) at <http://www.dechert.com/library/FS%20Update%202004-29.pdf>.

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