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A legal update from Dechert's Financial Services Group

SEC Issues Guidance on Hedge Fund Adviser 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 interpretive guidance (the "Letter")[1] on the hedge fund adviser registration rule (the "Rule") in response to a request by the American Bar Association Subcommittee on Private Investment Entities (the "Subcommittee")[2] for assistance in interpreting certain provisions of the Rule.[3]

In December 2005, Dechert's Financial Services Group issued a legal update highlighting two critical and time-sensitive issues addressed in the Letter.[4] This update is a more comprehensive discussion of the Division's positions and is intended primarily for hedge fund advisers that wish to remain exempt from registration, are in the process of registering, are already registered, or maintain their principal place of business outside the United States (*i.e.*, "offshore" advisers).

Issues Affecting Advisers Seeking to Remain Exempt from Registration

Redemptions and Transfers

Hedge fund managers may avoid registration by imposing a two-year lockup (the "Two-Year Lockup") on all capital contributions to a fund on or after February 1, 2006.[5] Advisers expressed frustration with the uncertain meaning of the phrase: "permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests." In response to the Subcommittee Request Letter, the Division provided some clarification as to the exact term for which investors must be required to hold interests prior to redemption in order to allow an adviser to rely on the Two-Year Lockup exception to the definition of private fund.

According to the Division, if an owner is permitted to redeem its interests in the fund prior to the second anniversary of the date of investment, then the fund "permits its owners to redeem any portion of their ownership interests

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1 *See American Bar Association Subcommittee on Private Investment Entities* (pub. avail. Dec. 8, 2005) available at http://www.sec.gov/divisions/investment/noaction/aba120805.htm.

2 The Subcommittee's request letter is available at http://www.sec.gov/divisions/investment/noaction/aba120805-incoming.pdf (the "Subcommittee Request Letter").

3 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 (the "Advisers Act" or the "Act"). See also Release No. IA-2333 (Dec. 2, 2004) ("Release No. IA-2333").

4 *Dechert OnPoint: SEC Staff Issues Guidance on New Hedge Fund Adviser Registration Rule* (Dec. 9, 2005) at http://www.dechert.com/library/FS_Update_27_12-05.pdf (discussing the Division's clarification of the two-year lockup exception as well as the Division's willingness to act quickly on Forms ADV filed by January 9, 2006).

5 The Division noted that "[t]he Adopting Release [for the Rule] makes it clear . . . that advisers are required to apply the two-year redemption test only to investments made on or after February 1, 2006." A redemption provision or side agreement relating to investments made prior to February 1, 2006 which allows for more frequent liquidity will not, itself, require treatment of the fund as a "private fund" under the Rule.

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within two years of the purchase of such interest" within the meaning of Rule 203(b)(3)-1(d)(1)(ii) under the Advisers Act, and therefore, the adviser cannot rely on the Two-Year Lockup exception. Put another way, in order for the adviser to rely on the Two-Year Lockup exception, investors must maintain their investment in the fund for two full years (*e.g.*, an investment made on February 1, 2006 could not be redeemed before February 1, 2008).

Hedge fund managers seeking to rely on the Two-Year Lockup exception from the definition of private fund should promptly review their offering documents to ensure that redemptions may only be effected after the expiration of two full years from the date of investment.

The Subcommittee also sought clarification as to the circumstances under which a transfer between classes of a multi-class fund would be considered to be a redemption for purposes of the Two-Year Lockup. In response, the Division indicated that a transfer from one class of a fund to another class of the same fund would not be considered a redemption for purposes of the Rule if the two classes share *the same* underlying portfolio of investment securities *and* provide investors with *the same* redemption rights.

However, transfers between classes of a fund which have "substantially similar" investment objectives (but not identical portfolios)[6] or different redemption rights[7] may constitute a redemption for purposes of the Rule. Ultimately, whether or not a transfer constitutes a redemption is a question of facts and circumstances.

Hedge fund managers that advise multi-class funds and seek to rely on the Two-Year Lockup should promptly review their offering documents to confirm that transfers between classes of shares are permitted only where both classes have the same underlying portfolio and redemption rights.

Additionally, the Division permits no distinction between U.S. investors and non-U.S. investors with respect to the Two-Year Lockup. If an investor, regardless of residency, is permitted to redeem its interest within two years of purchase, the adviser cannot rely on the Two-Year Lockup exception to the definition of "private fund."

However, under limited circumstances for purposes of the Two-Year Lockup, the Division has indicated that it would interpret a captive master-feeder structure as operating as an integrated structure, such that the adviser need look only to whether the investors in the feeder funds are permitted to redeem any portion of their interests in the feeder funds within two years of their purchases for purposes of the definition of "private fund" in Rule 203(b)(3)-1(d) under the Advisers Act.

Thus, the adviser to a fund so organized may look to the redemption provisions applicable to investors in the feeder funds rather than those applicable to the feeder funds' investment in the master fund for purposes of the Two-Year Lockup. Consequently, capital may be freely redeemed by the feeder funds from the master fund.

Extraordinary Events; Reinvestment of Gains

Rule 203(b)(3)-1(d)(2) under the Advisers Act allows advisers to rely on the Two-Year Lockup exception where more frequent redemptions are permitted only with respect to (1) extraordinary events and (2) "interests acquired through reinvestment of distributed capital gains or income." In order to help hedge fund managers interpret this provision, the Subcommittee sought further specific guidance from the Division as to the sort of events that may be considered to be extraordinary.

Under the Letter, the dissolution or liquidation of an "entity owner," *i.e.*, an investor that is a partnership, limited liability company, corporation or other type of entity, may be considered an extraordinary event where the entity ceases to operate and the adviser has a reasonable basis to believe that the entity owner's dissolution or liquidation is bona fide and not designed to avoid the relevant two-year redemption period. Furthermore, the Division indicated that the bankruptcy of an owner, whether an individual or an entity, would also be an extraordinary event. In such situations, an adviser may permit an investor that dissolves, liquidates or is in bankruptcy to redeem its interests within the two-year redemption period without causing the adviser to lose the ability to rely on the Two-Year Lockup.

Release IA-2333 indicated that extraordinary events may also include changes of circumstance within the adviser such as the death, disability, incapacitation or ceased involvement of key advisory personnel. The Subcommittee asserted that significant withdrawals by the adviser or its key personnel should similarly be consid-

[6] The Division indicated, in this regard, that if either class has investments that are not shared in the same proportion by the other, then the two classes would not be viewed as sharing the same underlying portfolio.

[7] Thus, a transfer from Class A shares that have a two-year lockup to Class B shares that have a one-year lockup would cause the fund to be deemed to be a "private fund."

ered to be extraordinary events within the contemplation of the Rule. The Division disagreed with the Subcommittee's assertion, noting that, unlike the death or incapacity of key personnel of the adviser, a significant withdrawal of an investment by an adviser or its principals is not an extraordinary event because such a withdrawal is generally within the adviser's discretion. Consequently, a side letter that gives investors special redemption rights in the event of a significant withdrawal by the adviser or its personnel would not be compatible with reliance on the Two-Year Lockup.

The Division's position on this issue adversely affects advisers that may enter into side letters permitting investors to withdraw early in the event of a significant withdrawal by the adviser or its key personnel. Fortunately, investments made prior to February 1, 2006 are not considered when determining an adviser's ability to rely on the Two-Year Lockup; *however, side letter arrangements entered into prior to that date may need to be modified with respect to subsequent investments in order to maintain reliance on the Two-Year Lockup. Similarly, side letters that permit early withdrawals as a result of poor investment performance would also preclude an adviser from relying upon the Two-Year Lockup, and accordingly, such side letter would need to be modified.*

Furthermore, the Division confirmed that following expiration of the initial two-year lockup period, an investor may redeem not only its original investment, but also any gains or income and subsequent appreciation on those gains or income, without triggering the definition of "private fund."

Redemptions by the Adviser's Personnel

Interestingly, while the adviser and its principals and other knowledgeable employees ("insiders") who invest in a fund managed by (or are otherwise clients of) the adviser are not counted towards the fifteen client threshold to trigger registration, the Division has indicated that such insiders must be equally subject to the Two-Year Lockup as an outside investor would be. The Division reasoned that "owner", for purposes of Rule 203(b)(3)-1(d)(1)(ii) under the Advisers Act, includes anyone who owns an interest in a pooled investment vehicle, including such insiders. The Division believes that because subjecting insiders to the Two-Year Lockup prevents insiders from enjoying preferential liquidity terms not available to other investors, its interpretation is consistent with the SEC's objectives in adopting the Rule (*i.e.*, investor protection).

Advisers relying on the Two-Year Lockup exception should adopt policies and controls to monitor redemptions by their employees.

Deferred Fees

Fund managers (both registered and unregistered) to offshore funds sometimes defer fees, including incentive fees. The Subcommittee expressed concern that the Two-Year Lockup might be interpreted to prevent withdrawal by the adviser of deferred fees earned—particularly if the adviser is considered to be an "owner" of the fund—and requested the Division's agreement that such withdrawals will not be inconsistent with the Two-Year Lockup.

While disagreeing with the Subcommittee's general argument that the adviser is not an "owner", the Division agreed that advisers may withdraw deferred incentive fees and allocations earned without surrendering the ability to rely on the Two-Year Lockup. The Division views deferred performance incentive fees and accrued allocations of performance compensation to be compensation for services provided by the adviser and the general partner rather than contributions of capital, which would be subject to a Two-Year Lockup. *Consequently, an adviser or its affiliated general partner (or managing member) may withdraw deferred fees or incentive allocations that were reallocated to its capital account at any time and still meet the requirements for the Two-Year Lockup exception.*

Transfers

Additionally, the Division has indicated that the original purchase date may be attributed to an interest transferred in a secondary market transaction provided that there has been no arrangement between the fund or the adviser and either investor to circumvent the Two-Year Lockup.

Family Funds

Family funds are treated the same as any other fund for purposes of the Rule. All owners of a family fund that meets the definition of "private fund" provided by Rule 203(b)(3)-1(b)(1) under the Advisers Act, including family members, must be counted as provided under Rule 203(b)(3)-2(a) when determining whether the adviser is required to register under the Advisers Act.

However, under Rule 203(b)(3)-1(a)(1), a natural person may be "aggregated" with:

- His or her minor children
- Other family members sharing the same residence
- All trusts[8] or other accounts of which that person and his minor children or family members sharing the same residence are the only primary beneficiaries

In such circumstances, the "aggregated" persons count as a single client.

The Registration Process

Completing Part I of Form ADV

The Subcommittee requested guidance as to how an adviser to funds operated in a master-feeder structure should complete Form ADV, Part I, Schedule D, Section 7.B. In response, the Division noted that, if both the master fund and the feeder funds are investment-related limited partnerships or limited liability companies having the adviser or a related person as their general partner or managing member, or are otherwise private funds advised by the adviser, then the adviser is to identify both the feeder funds and the master fund, and provide the current amount of total assets in each.

Advisers may wish to indicate, in the field naming the feeder fund(s), that such funds are invested solely in a specific master fund.

Compliance Issues For Registered Advisers to Hedge Funds

Custody

Advisers to private funds may choose to comply with certain provisions of the Custody Rule,[9] by providing investors with a copy of the fund's audited financial statements within 120 days of the fund's fiscal year end (180 days for funds of funds) (the "Annual Audit Exception") in lieu of the more burdensome alternative of distributing account statements to investors on a quarterly basis. However, such audited financials must be fully compliant with generally accepted accounting principles ("GAAP").

It is common practice for advisers, particularly advisers to start-up funds, to amortize the start-up costs of a fund over a five year period so that initial investors do not disproportionately bear the burden of such organizational costs. Such an approach is not fully compliant with GAAP and may result in the fund's auditor issuing a qualified audit opinion if the auditor considers the amortization of start-up costs material in relation to the total amount of assets under management.

The Subcommittee requested that advisers be permitted to rely on the Annual Audit Exception notwithstanding the amortization of start-up costs. However, the Division refused to soften the Custody Rule's strict requirement that a fund's financial statements be fully GAAP compliant in order for an adviser to rely on the Annual Audit Exception. As such, if an adviser's amortization is deemed material and therefore the auditor issues a qualified audit opinion, the adviser would not be able to rely on the Annual Audit Exception. Of course, cost allocation methods which are consistent with GAAP would be permissible.

Books and Records

In general, a registered investment adviser is required to maintain its books and records in "an appropriate office of the investment adviser."[10] It is common practice for advisers of non-U.S. domiciled funds to appoint an administrator. The Division confirmed that advisers may engage an administrator to maintain and preserve, on the adviser's behalf, the books and records required to be kept pursuant to Rule 204-2 under the Advisers Act provided that the following two conditions are satisfied:

- The administrator acts as a service provider to the adviser in maintaining, preparing, organizing and/or updating the adviser's records for the adviser's ongoing use in its business, and does not merely provide long-term storage of the records

[8] It is not necessary that a family member serve as trustee.

[9] *See* Rule 206(4)-2 under the Advisers Act. See also Release No. IA-2176 (Sept. 25, 2003).

[10] Rule 204-2(e)(1) under the Advisers Act. Generally, advisers maintain such books and records at their principal place of business.

- Upon request of the SEC's staff, the records are produced promptly for the staff at the appropriate office of the adviser or an office of the administrator

By permitting advisers to maintain their books and records with the administrator, advisers are relieved from the burden of maintaining a duplicate set of books and records on site. Moreover, the Division recognized that the administrator may act as a service provider for the adviser for these purposes even if the administration agreement is actually with the fund or its general partner.

Books and Records of Non-U.S. Domiciled Funds that Have an Independent Board of Directors

The Division also confirmed that, if neither the adviser nor any of its related persons acts as the private fund's general partner, managing member, or in a similar capacity, Rule 204-2(1) under the Advisers Act does not cause the books and records of the private fund to be the records of the adviser. Although the Subcommittee's question indicated that a majority of the fund's directors would be unaffiliated with the adviser, the Division did not condition its response on the presence of an independent board.

In practice, this position affects advisers to non-U.S. domiciled funds that are formed as corporations. If a fund is formed as a corporation, the adviser is neither a general partner nor a managing member of the fund. Rather, the adviser acting as investment manager is deemed to be a service provider to the fund.

Rebalancing Fund Portfolios

Section 206(3) of the Advisers Act significantly restricts the ability of an adviser to engage in "principal transactions" and "agency cross transactions," and generally requires that an adviser obtain client consent to such transactions prior to completion, following written disclosure by the adviser.[11] Advisers to multiple funds having the same strategy may find that their funds' portfolios become unbalanced as a result of contributions and redemptions and, consequently, may wish to trade securities between such funds for the purpose of rebalancing.[12] Under certain circumstances, funds managed by an adviser might be considered to be proprietary accounts of the adviser—perhaps as a result of investment by the adviser and its personnel in the fund—and transactions between such funds (or the fund and another account) would be subject to the Act's restrictions on principal transactions.[13]

The Division did not provide an unequivocal response as to whether rebalancing transactions among an adviser's unregistered funds would be viewed as principal transactions subject to the notice and consent requirements of Section 206(3) of the Advisers Act nor did the Division provide a specific percentage of ownership by an adviser and its personnel in an unregistered fund that would cause the fund to be viewed as a proprietary account of the adviser for purposes of Section 206(3).

Instead, the Division noted that the application of Section 206(3) to such rebalancing transactions would depend upon the relevant facts and circumstances.[14] Specific factors that should be considered in determining whether Section 206(3) applies include "the extent of the ownership interest of the adviser and/or its personnel in the fund as well as the relationship of the personnel to the adviser."

As such, advisers that permit their principals and employees to invest in their unregistered fund and that engage in rebalancing should adopt controls and procedures to monitor the aggregate ownership interests of

[11] Section 206(3) of the Advisers Act makes it unlawful for any investment adviser, directly or indirectly "acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction." Rule 206(3)-2 allows for prior "blanket" consent to agency cross transactions under certain circumstances.

[12] When a hedge fund manager engages in rebalancing, the manager sells securities from one or more funds and purchases the securities for one or more of the other funds in a simultaneous transaction so that each fund maintains the same pro rata ownership of each securities position.

[13] The Subcommittee had specifically requested, among other things, that the Division "provide guidance as to the threshold percentage of an unregistered pool that must be owned by the fund's investment adviser and the adviser's personnel before the pool must be viewed as a principal account" *See* Subcommittee Request Letter, *supra* note 2.

[14] The Division invites managers to seek guidance as to the applicability of Section 206(3) to rebalancing. Such advisers should provide the Division "with specific factual information and should explain how the transactions may implicate section 206(3) and whether they raise the concerns underlying that section (*i.e.*, price manipulation and dumping)."

the adviser and its principals and employees in the fund so that the adviser may determine whether Section 206(3) of the Advisers Act should apply with respect to the adviser's rebalancing transactions.

Perhaps more importantly, the Division reminded advisers that rebalancing transactions, whether principal transactions or otherwise, may create a conflict of interest. The Division noted that Sections 206(1) and (2) of the Advisers Act impose a fiduciary duty on advisers with respect to their clients and a duty of full and fair disclosure of all material facts.

According to the Division, those provisions may require an adviser to disclose information about rebalancing transactions and transactions effected by the adviser involving an unregistered fund in which the adviser and/or its personnel have an ownership interest, *regardless* of whether Section 206(3) of the Advisers Act also applies. *This statement suggests that advisers that engage in rebalancing transactions among unregistered funds should disclose this practice and describe the methods used to rebalance fund portfolios in Part II and Schedule F of Form ADV even if the ownership percentage of the adviser and/or its personnel would not be significant enough to cause the transaction to be deemed to be a principal transaction*.

Additionally, Rule 206(4)-7 under the Advisers Act requires registered advisers to maintain compliance policies and procedures reasonably designed to prevent violation of the Act and rules thereunder by the adviser and its associated persons. Accordingly, advisers engaged in rebalancing should adopt policies and controls to monitor rebalancing to demonstrate, among other things, that rebalancing is not being done to favor one fund over another fund.

SPVs Do Not Have to Register if the Affiliated Adviser Is Already Registered

Many U.S.-domiciled hedge funds are structured so that there is a general partner of a limited partnership in addition to a separate investment manager.[15] The investment manager itself would be registered as an investment adviser. Both the general partner and the investment manager are owned and operated by the same persons and have the same employees. The Division's concurrence that a special purpose vehicle ("SPV") established to act as a general partner or managing member of a private fund that is an affiliate of a registered investment adviser is not required to register as an investment adviser as well, is, therefore, welcome relief to the U.S.-based hedge fund community.

Although the SPV would not have to register, its investment advisory activities would be subject to the Advisers Act and the rules thereunder, and the SPV would be subject to examination by the SEC staff. Moreover, an SPV established to act as a general partner or managing member of a private fund, along with all of its employees and the persons acting on its behalf, would be considered "persons associated with" the registered investment adviser so that the SEC could enforce the requirements of the Advisers Act against the SPV, those persons, and the registered investment adviser.[16] *Accordingly, the SPV should be treated and operated as if it were, itself, a registered investment adviser. In particular, the SPV should be made subject to the related adviser's compliance policies and procedures and its personnel subject to the related adviser's supervision and control*.

Issues Specific to Offshore Advisers

Non-U.S. Based Sub-Advisers

Although the Division determined that U.S. sub-advisers generally would be subject to the same requirements under the Rule as any other adviser to a private fund, the Division provided limited relief for non-U.S. sub-advisers. Unless otherwise subject to registration, a non-U.S. based sub-adviser to a private fund is not required to register as an investment adviser with the SEC provided:

- The sub-adviser is hired (and subject to being discharged) by the private fund's adviser that is registered with the SEC ("primary adviser")
- The sub-adviser is not otherwise required to register with the SEC
- The sub-adviser does not control, is not controlled by, or is not under common control with the fund's primary adviser
- The written materials provided to the fund's investors clearly disclose that a portion of the

[15] The reason for the establishment of two entities is to achieve certain tax efficiencies.

[16] For example, any disciplinary history that the SPV would have been required to disclose on Form ADV had it registered as an investment adviser would be disclosed on the affiliated registered investment adviser's Form ADV.

fund's assets may be managed by one or more offshore sub-advisers not registered with the SEC

- At the time the sub-adviser is hired, and at the time any additional assets of the fund are allocated to the sub-adviser for management, the sub-adviser does not manage more than 10% of the fund's total assets

Additionally, the Division noted that the primary adviser retains responsibility for ensuring that all of the fund's assets are maintained in accordance with the requirements of the Custody Rule.

Foreign Affiliates

The Division also confirmed that, with regard to the registration of affiliated entities, registered advisers (whether U.S. based or "offshore") and their non-U.S. affiliates may rely on the relief provided in previous no-action letters to the extent that their facts and circumstances are substantially similar to those described in no-action letters issued to, among others, Unibanco and Royal Bank of Canada with respect to the use of participating affiliates.[17]

[17] *See, e.g., Uniao de Banco de Brasileiros S.A.* (pub. avail. July 28, 1992) ("Unibanco") *and Royal Bank of Canada, et al.,* (pub. avail. June 3, 1998).

Conclusion

Although the Letter clarifies a number of issues which had caused significant confusion in the hedge fund adviser community, a number of open issues remain. Unregistered hedge fund managers that seek to remain unregistered must be vigilant in preserving their exemption(s). Hedge fund managers that are registered should carefully consider their compliance obligations and undertake to review their policies and procedures periodically to ensure that their operations are in compliance with the Advisers Act.

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