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A legal update from Dechert's Financial Services Group

SEC Hedge Fund Adviser Registration Rule Overturned

Practical Implications for Non-U.S. Advisers

Summary

The U.S. Court of Appeals for the District of Columbia has invalidated rules requiring certain hedge fund advisers to register with the U.S. Securities and Exchange Commission ("SEC") as investment advisers. The SEC has decided not to appeal the court's ruling, and is instead moving ahead on an aggressive agenda of rulemaking in light of the court's decision. Hedge fund advisers should consider the practical implications of the court's decision.

Background

The U.S. Court of Appeals for the District of Columbia has invalidated the SEC's rules that, among other things, required more hedge fund advisers to register as investment advisers by changing the definition of "client" for purposes of the "private adviser exemption" under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act").[1]

Any investment adviser that has had fewer than fifteen "clients" in the last 12 months may rely on the private adviser exemption to avoid registration as long as the adviser does not "hold itself out" as an investment adviser.[2] For non-U.S. advisers, only U.S. clients must be counted. Under the original regulatory regime, the SEC had, by rule, defined the collective vehicle, rather than its investors, as the client for this purpose. The SEC then amended the rule in 2004 to require advisers to "look-through" hedge funds to count the investors in a fund as clients of the adviser for purposes of determining the number of "clients". The SEC did this by redefining "client" to mean the investors in a hedge fund for some, but not all, purposes under the Advisers Act.[3]

U.S. Court Throws Out Rule

In vacating the rules, the court stated that the SEC's "look-through" rule was arbitrary, strayed too far from the plain language of the statute, and was beyond what Congress intended when it passed the Advisers Act. In particular, the court was concerned that the rule purported to change the definition of "client" for purposes

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1 *See Goldstein et al. v. Securities and Exchange Commission*, Slip Op. No. 04-1434 (D.C. Cir. 23 June 2006). *See also Dechert OnPoint: Court Overturns SEC Hedge Fund Rule* (June 2006).

2 *See* Section 203(b)(3) of the Advisers Act. The Section exempts an adviser from registration if it (i) has had fewer than fifteen clients during the preceding twelve months, (ii) does not hold itself out generally to the public as an investment adviser, and (iii) is not an adviser to any investment company registered under the U.S. Investment Company Act of 1940.

3 *See Registration Under the Advisers Act of Certain Hedge Fund Advisers; Final Rule*, 69 Fed. Reg. 72,054 (10 December 2004). *See also Dechert Financial Services Update: SEC Releases Staff Report on Hedge Funds* (23 October 2003); *Dechert OnPoint: The SEC Proposal to Register Hedge Fund Advisers* (August 2004); *Dechert OnPoint: The U.S. SEC Adopts Rules to Require Hedge Fund Advisers to Register* (27 October 2004); *Dechert OnPoint: The SEC Publishes Final Rule Requiring Hedge Fund And Certain Other Private Fund Advisers to Register* (January 2005); *Dechert OnPoint: SEC Staff Issues Guidance on New Hedge Fund Adviser Registration Rule* (December 2005); and *Dechert OnPoint: SEC Issues Guidance on Hedge Fund Adviser Rule* (February 2006).

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of the private adviser exemption, but did not apply the same definition to other uses of the term in the Advisers Act. The effect of the court's ruling is that hedge funds no longer have to "look through" to their underlying investors for purposes of determining whether there are fewer than 15 clients, and many hedge fund advisers will no longer need to remain registered as investment advisers with the SEC.

The SEC has indicated that it will aggressively pursue new rulemaking as a result of the court's decision. For example, SEC Chairman Christopher Cox stated that the SEC will propose a new anti-fraud rule under the Advisers Act that would have the effect of "looking through" a hedge fund to its investors. The rule would, in the Chairman's words, "clearly state that hedge fund advisers owe serious obligations to investors in the hedge funds". The SEC also is considering whether it should increase the minimum asset and income requirements for individuals eligible to invest in hedge funds. The SEC Chairman stated in testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs that the current standard "is decades old [and] is not only out of date, but wholly inadequate to protect unsophisticated investors from the complex risk of investment in most hedge funds".[4]

It is also possible that Congress could, in effect, reverse the court case through legislation. Indeed, a bill has been introduced in Congress which would have the effect of reversing the case, but the prospect of legislation regarding hedge fund adviser registration is uncertain. It also has been proposed that the U.S. Federal Reserve assume oversight of hedge funds, and that hedge funds make quarterly reports to the Federal Reserve on their assets, liabilities and leverage.

Practical Implications for Hedge Fund Managers

Q. Should hedge fund advisers who registered with the SEC solely because of the rule consider waiting to de-register?

A. Given that the SEC is aggressively pursuing new rulemaking in response to the court's decision, and that Congress could pass new legislation in this area as well, advisers may wish to await further developments. However, advisers should keep in mind that they should seek to de-register no later than 1 February 2007, if they wish to rely on certain exemptions provided by the SEC, as discussed more fully in the questions below.

Q. Can hedge fund advisers who registered with the SEC solely because of the rule remain registered if they wish?

A. Advisers are not required to rely on the private adviser exemption. As long as an adviser meets the definition of investment adviser (advising others as to securities for compensation) and has $25 million in assets under management *or* is based outside the United States, that adviser may stay registered with the SEC.[5]

Early anecdotal evidence suggests that a clear majority of new registrants will choose to remain registered, although the intentions of non-U.S.-based advisers are likely to be more negative. The main reasons given for staying registered are for marketing reasons and because "best practices" are now in place.

Q Are non-U.S. hedge fund advisers relying on the "lite" regime able to continue following the "lite" regime?

A. The "lite" regime lets advisers based outside of the U.S. avoid having to comply with many of the substantive requirements of the Advisers Act, such as having a written compliance program and the cash solicitation rule, among others. Since the origin of the "lite" regime is from no-action letters written by the SEC staff, the SEC has confirmed that advisers can still rely on the "lite" regime with respect to such adviser's dealings with offshore funds and other offshore clients to the extent described in and consistent with the SEC's no-action positions and the vacated rule.[6] Advisers under the "lite" regime must keep in mind, of course, to comply with all of the Advisers Act as well as the SEC's rules thereunder with respect to any U.S. clients (and any prospective U.S. clients) they may have.

Q. Could an adviser which held itself out as an investment adviser or has taken on more than 14 clients (counting each private fund as a single client) still de-register?

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4 Based on the Chairman's prepared testimony, it seems likely that the revised standard may more closely match the "qualified client" standard applicable to the assessment of performance fees under the Advisers Act and could exclude the investor's primary residence. *See* the Managed Funds Association's *White Paper on Increasing Financial Eligibility Standards for Investors in Hedge Funds* (7 July 2003), suggesting that the "accredited investor" standards of the Securities Act of 1933 be amended to increase the standards of financial eligibility for natural persons investing in pooled investment vehicles.

5 *See* Section 202(a)(11) and Section 203 of the Advisers Act.

6 *ABA Subcommittee on Private Investment Entities* (pub. avail. 10 August 2006).

A. An investment adviser could still de-register in this instance, provided that the adviser:

- Ceases to hold itself out to the public as an investment adviser
- Reduces the number of clients it has to 14 or fewer by the date it withdraws, and
- Withdraws its registration on Form ADV-W with the SEC by no later than 1 February 2007

Q. What steps are required to de-register?

A. If an adviser wants to de-register and qualifies for an exemption from registration, that adviser should file Form ADV-W electronically with the SEC and officially de-register. The withdrawal becomes effective after the SEC receives the filing and determines that it is not deficient.

Q. Does a hedge fund adviser have to file a balance sheet on Schedule W2 of Form ADV-W (in response to Item 7) if the adviser has custody of client assets (as indicated by a "yes" answer to Item 3 of Form ADV-W)?

A. The SEC has stated that a hedge fund adviser who de-registers by 1 February 2007 does not have to provide a balance sheet on Schedule W2 as a result of having custody of client assets (as indicated by a "yes" answer to Item 3). Although most hedge fund advisers have custody of client assets, they are no longer required to file a balance sheet with the SEC in connection with their annual update of their Form ADV registration form.[7] Therefore, as a matter of fairness, the SEC is not requiring hedge fund advisers to prepare and file a balance sheet as a condition of de-registering (provided the de-registration occurs before 1 February 2007).

Q. What are the ongoing compliance obligations for investments advisers who de-register as advisers with the SEC?

A. The adviser is required by Rule 204-2(e) under the Advisers Act to maintain certain required books and records for five years and to notify the SEC of their location.

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The new U.S. Pension Protection Act of 2006 has changed the 25% benefit plan investor calculation for hedge funds monitoring investment by benefit plan investors. Please see our client alert at www.dechert.com or contact any of the lawyers listed on the next page for information.

[7] See Section II.E. of *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2176 (25 Sept. 2003) (amending Form ADV to eliminate the requirement that advisers with custody include an audited balance sheet in their brochures to clients).

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