

Is Deregistration as an Adviser with U.S. SEC an Option?

1 February 2007 Deadline Approaches

Summary

Last summer, the U.S. Court of Appeals for the District of Columbia overturned rules requiring certain hedge fund advisers to register with the U.S. Securities and Exchange Commission (SEC) as investment advisers. The SEC decided not to appeal the court's ruling, and is instead pursuing a separate rulemaking agenda. As a result, many hedge fund advisers that registered with the SEC have already deregistered, and others are now contemplating deregistration. Those advisers opting to deregister should complete the process by no later than 1 February 2007 in order to take advantage of relief provided by the SEC staff.

Background

The U.S. Court of Appeals for the District of Columbia 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 the purposes of the "private adviser exemption" under the U.S. Investment Advisers Act of 1940, as amended (the Advisers Act).¹

Any investment adviser who has had fewer than 15 "clients" in the last 12 months may rely on the private adviser exemption to avoid registration, so long as the adviser does not "hold itself out" as an investment adviser.² For

non-U.S. advisers, only U.S. clients need to be counted. Under the original rules, the SEC had defined a collective investment vehicle, such as a hedge fund, rather than its individual 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 in order to determine the number of "clients" the adviser had.

The court vacated the rules, holding that the SEC had exceeded its authority to promulgate interpretive rules under the Advisers Act. The court held that the "look through" rule was arbitrary, strayed too far from the plain language of the Advisers Act, and was beyond what Congress intended when it passed the Advisers Act. The SEC declined to appeal the decision. Instead, the SEC has proposed new rules in light of the court's decision, none of which will employ a "look through" mechanism to determine an adviser's number of clients or otherwise extend the registration requirement.³

Hedge fund advisers who registered with the SEC in reliance on the now-overturned "look through" rule may be contemplating whether to stay registered. Because the SEC has conditioned certain relief on whether an adviser de-registers by 1 February 2007, now is the

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); *Dechert OnPoint: SEC Hedge Fund Adviser Registration Rule Overturned – Practical Implications for Non-U.S. Advisers* (August 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 15 clients during the preceding 12 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 or a company that has elected to be treated as a business development company.

³ Dechert LLP is currently preparing a *Dechert OnPoint* describing these new rule proposals.

time for those advisers to consider whether deregistration is an option.

What Are the Benefits for Advisers Who Deregister by 1 February 2007?

The SEC has confirmed that an adviser who, during the period it has been registered due to the overturned rule, had held itself out as an investment adviser (e.g., advertised its services as an adviser) or had taken on more than 14 clients (counting each private fund as a single client) within the last 12 months, may still deregister. Such an adviser must cease to hold itself out to the public as an investment adviser, and must reduce its number of clients (limited to U.S. clients for non-U.S. advisers) to 14 or fewer by the date it deregisters. In addition, if a hedge fund adviser or a related person had custody over client cash or securities (which would be indicated in Item 9 of Part I of Form ADV), the hedge fund adviser will not be required to provide an unaudited balance sheet when submitting its withdrawal form to the SEC. This relief is conditioned on the adviser withdrawing its registration with the SEC by no later than 1 February 2007.

There is no legal requirement that an adviser remain SEC-registered if it has had fewer than 15 "clients" (limited to U.S. clients for non-U.S. advisers) in the last 12 months, and if it does not hold itself out as an investment adviser. So long as an adviser qualifies for this exemption and has no business purpose for remaining registered, it makes sense to deregister now in order to receive the benefits extended to those advisers who deregister by 1 February 2007.

What Are the Benefits for Advisers Who Elect to Remain Registered?

The SEC staff has affirmed that it will permit advisers who registered due to the overturned rule and who decide to remain registered with the SEC to take advantage of certain benefits extended to them by the rules that were overturned. Those advisers are permitted to do the following:

- Present their past performance information for periods prior to 10 February 2005, even if the adviser did not otherwise have all of the supporting records otherwise required by Rule 204-2(a)(16) under the Advisers Act, in accordance with the overturned portion of that rule. An adviser choosing to rely

on this provision must continue to preserve any of its books and records that relate to its performance for periods prior to 10 February 2005

- Continue charging a performance fee to investors and other advisory clients who were investors or clients of the adviser prior to 10 February 2005, regardless of whether such investors or clients meet the definition of a "qualified client," as defined in Rule 205-3(c) of the Advisers Act
- Deliver audited financial statements of a fund of funds, meeting certain requirements, to investors within 180 days of the fund's fiscal year, rather than within 120 days (as required for other types of hedge funds)

Why Might an Adviser Choose to Remain Registered?

A hedge fund adviser may remain registered with the SEC so long as it meets the definition of investment adviser (advising others as to securities for compensation) and either has \$25 million in assets under management *or* is based outside of the United States.⁴

Hedge fund advisers who currently offer their services to U.S. clients or who have plans to develop the U.S. market for their services may wish to remain registered with the SEC. In addition, investment advisers who have obtained Qualified Professional Asset Manager (QPAM) status under the U.S. Employee Retirement Income Security Act of 1974, as amended, or who will seek to qualify for such status, must remain registered as investment advisers as a prerequisite to QPAM status.⁵ Finally, hedge fund advisers may wish to stay registered with the SEC because it is attractive for marketing reasons, or because "best practices" are now in place.

Registration, however, has certain consequences, including recordkeeping responsibilities and continuing SEC staff inspection authority with

⁴ See Section 202(a)(11) and Section 203 of the Advisers Act.

⁵ QPAM status affords fund managers a relaxation of the rules prohibiting transactions with "parties in interest" that otherwise apply to advisers managing Benefit Plan Investor assets in excess of 25 percent of any class of a fund.

respect to the time during which the adviser is registered. As such, those advisers who qualify for a registration exemption and who are not, or do not intend to be, QPAMs, should seriously consider deregistration.

Is “Registration Lite” Affected by the Ruling?

The “registration lite” regime permits advisers based outside of the U.S. to 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. Under this regime, advisers must comply with the requirements relating to the filing and maintenance of Form ADV, the maintenance of certain records and the anti-fraud provisions of the Advisers Act, and inspection by SEC examiners. The regime is available provided the adviser has no direct U.S. clients (*i.e.*, it may have U.S. investors in funds it advises but may not take on any U.S. separate account clients).

The origin of the “lite” regime was from no-action letters written by the SEC staff. The SEC has confirmed that advisers may 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 rules.⁶ An adviser loses the “lite” regime, and must comply with all provisions of the Advisers Act, as well as the SEC’s rules thereunder, if it takes on even one direct U.S. client.

Registered non-U.S. hedge fund advisers may choose to remain registered under the “lite” regime. However, deregistration may offer more flexibility with regard to U.S. clients for those advisers who qualify for a registration exemption. For example, a non-U.S. hedge fund adviser relying on the “lite” regime that enters a contract with just *one* U.S. separate account client would then be subject to full regulation. In contrast, were that adviser to choose to deregister, it would then be able to take on up to 14 U.S. separate account clients without being subject to SEC regulation.

What Does the Deregistration Process Require?

If a hedge fund adviser wishes to deregister with the SEC and qualifies for an exemption from registration, that adviser should file Form ADV-W electronically with the SEC in order to officially deregister. The withdrawal will become effective once the SEC receives the filing and determines that it is not deficient.

If the adviser or a related person of the adviser had custody over client cash or securities, Item 7 of Form ADV-W requires an adviser to include on Schedule W2 an unaudited balance sheet of the adviser as of the end of the month prior to the filing of the Form, prepared in accordance with generally accepted accounting principles. The SEC has stated that an adviser who registered because of the now-vacated rules and subsequently deregisters by **1 February 2007** would still need to complete a Schedule W2, but may enter “0” for all entries on Schedule W2 and need not provide an unaudited balance sheet. Those advisers who decide to deregister after 1 February 2007 must provide those unaudited financials.

It is important to note that there are ongoing compliance obligations for advisers who deregister with the SEC. 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. Also, some of the anti-fraud provisions of the Advisers Act apply even to unregistered advisers, and the SEC has jurisdiction even if the adviser is not required to register.



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⁶ See American Bar Association Subcommittee on Private Investment Entities (pub. avail. 10 Aug. 2006).

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