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The Clock Is Ticking

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The clock is ticking

With the February 2006 deadline for SEC registration rapidly approaching, partners at law firm Dechert LLP explain the ins and outs of SEC rules and requirements

Almost a year ago, the US Securities and Exchange Commission (SEC) adopted its long-awaited proposal to require hedge fund managers to register as investment advisers. The new rule requires hedge fund advisers with more than 14 investors and US$30m under management to register; smaller advisers are potentially subject to state registration requirements.

The rule is intended to exclude from the registration requirement advisers to private equity and venture capital funds by excluding funds that do not provide redemption rights within two years following an investment. Special rules apply to non-US advisers, which may avoid many of the requirements of SEC registration if their only US clients are investors in offshore funds. Fewer than five months remain before the 1 February 2006 deadline. By this date, covered hedge fund managers must register and develop and implement comprehensive compliance policies.

Background

Many hedge fund advisers currently avoid registration under the Investment Advisers Act of 1940 (Advisers Act) by relying upon the 'private adviser' exemption contained in the Advisers Act. An investment adviser is not required to register with the SEC if it has had fewer than 15 clients during the preceding 12 months and neither holds itself out to the public as an investment adviser nor acts as the investment adviser to a mutual fund registered with the SEC under the Investment Company Act of 1940 (Investment Company Act).

A hedge fund has historically been counted as one client for these purposes. As a result, investment advisers that advise hedge funds have been able to treat each fund managed as a single client, which has made it possible for hedge fund managers to avoid SEC registration.

On 2 December 2004 the SEC adopted a new rule (Rule) – registration under the Advisers Act of Certain Hedge Fund Advisers – that will require an investment adviser to 'look through' certain funds and count each investor in the fund as a client for the purposes of determining whether the adviser has more than 14 clients.

Rationale for the Rule

The Rule follows a report on the Implications of the Growth of Hedge Funds (*Staff Hedge Fund Report*) released in autumn 2003 by the SEC staff. A report which accompanied the issuance of the initial proposal to adopt the Rule stated the Commission action was based on the following considerations, many of which echo the *Staff Hedge Fund Report*:

- Growth of hedge funds: Over the past 10 years, the estimated assets in US hedge funds have increased fifteen-fold, and the number of hedge funds has increased more than five-fold. Hedge funds play a growing role in the US securities markets as large and frequent traders of securities. For example, the SEC noted hedge funds account for about 95% of all trading in convertible bonds. However, due to their unregulated nature and the absence of registration requirements for hedge fund managers, the SEC asserted it lacks reliable information about the hedge fund industry.

Structure of hedge funds

Hedge funds are generally structured to come under the 'private' investment company exceptions from the definition of investment company found in Section 3(c)(1) and 3(c)(7) of the Investment Company Act in order to avoid registration and regulation thereunder. In order to satisfy Section 3(c)(1) and 3(c)(7), the hedge fund must not conduct a public offering of its shares and generally must, for 3(c)(1) purposes, limit the number of its investors to less than 100 persons, and, for 3(c)(7) purposes, its investors must be limited to persons who are 'qualified purchasers'. Offshore funds may generally apply the counting or qualification requirements just to their US investors and limit the private offering requirement to offers made in the US.

- Growth of hedge fund fraud: the SEC claimed the growth in hedge funds has been accompanied by a substantial and troubling growth in the number of hedge fund fraud enforcement cases. Hedge fund fraud involves, in particular, investment advisers that overstate the performance of their hedge funds; advisers that cause hedge funds to pay unnecessary and undisclosed commissions; advisers that misappropriate client assets; and advisers to hedge funds that have allegedly been key participants in the recent scandals involving mutual fund late trading and inappropriate market timing.
- 'Retailisation' of hedge funds: the SEC noted there is a growing exposure of smaller investors, pensioners, and other market participants, directly or indirectly, to hedge funds. For example, the development of retail funds of hedge funds in recent years has made hedge funds more broadly available to the public and a growing number of public and private pension funds, and now foundations and charitable organisations have begun to invest in hedge funds or have increased their allocations to hedge funds.

Specific provisions

Under the Rule, an investment adviser whose principal office and place of business is in the US must count each investor in the 'private fund' as a client. An investment adviser whose principal office and place of business is located outside the US will only be required to count investors in the private fund that are US residents for the purpose of determining the availability of the exemption.

Similarly, the Rule will permit an offshore adviser to treat an offshore private fund as its client (and not the investors) for most purposes under the Advisers Act. Moreover, because an offshore fund would not be a US client of the offshore adviser, the Advisers Act's substantive provisions generally would not apply to the adviser. The offshore adviser will be required to comply with the Advisers Act's record-keeping requirements and will have to undertake to provide promptly such records to the SEC upon request. It will also be required to make its personnel available for testimony before, or questioning by, the SEC or its staff.

Definition of private fund: The Rule defines a 'private fund' as a company (i) that would be an investment company, but for the exceptions provided in sections 3(c)(1) or 3(c) (7) of the Investment Company Act *(see box on page 28)*, (ii) that permits owners to redeem any portion of their ownership interests within two years and (iii) which offers interests based on the investment advisory skills, ability or expertise of the investment adviser.

What to do next

If a manager has not already done so, those hedge fund managers covered by the Rule should start the registration process immediately. Due to the lead time required, it may not be possible for a manager to register and become fully compliant by the deadline if they wait much longer. While the registration process is not complex, managers should not underestimate the time re-

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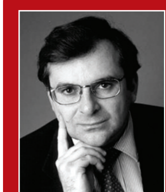

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quired to develop and implement the compliance infrastructure that will be required.

The actual registration process requires the preparation of SEC Form ADV. This form consists of two parts and has several schedules which must be completed in order to supplement the information provided in the 'check the box' portions of the form.

Part I must be electronically filed through the Investment Advisor Registration Depositary (IARD), a system maintained for the SEC by the NASD. To file the form, the manager must first obtain a filer ID and pay a prescribed fee. Completion of Part I requires the disclosure of detailed information concerning the adviser, including its location, key personnel, disciplinary history, ownership of the adviser and a listing of the funds advised by the adviser. It is important to note Part I of the form is publicly available to anyone interested in reviewing the information.

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Part II of the form must also be prepared, but need not be filed with the SEC. It must however, be made available to the SEC upon request and must be furnished to all clients of the adviser. Part II requires detailed disclosure of fee arrangements, the types of products offered, the research process, brokerage allocation policies, conflicts involving affiliates, conflicts involving other clients, proxy voting policies and policies involving personal trading by employees of the adviser.

It is important to ensure the information in the form is current and consistent with both actual company policies and practices, as well as the disclosure in the private placement memorandum and marketing materials provided to investors. Because of the broad anti-fraud provisions in the Investment Advisers Act, inconsistencies, or the disclosure of inaccurate or out-of-date information can subject a manager to significant liability.

Compliance policies and compliance infrastructure: SEC Rules require registered advisers to adopt policies and procedures which are reasonably designed to prevent, detect and remedy violations of the Advisers Act. The SEC understands that violations will inevitably occur. What is critical is to develop a culture of compliance and a compliance infrastructure, in which violations are not tolerated, identified when they occur and promptly remedied.

An essential part of this process is to designate a chief compliance officer (CCO). Advisers have considerable flexibility in designating the appropriate person, based upon the nature and size of the business. The CCO does not need to be full-time, may perform other duties and a significant portion of the compliance functions may be outsourced. However, the CCO must be 'empowered' and must have sufficient training and experience to effectively perform the job.

Compliance systems: Some unregistered advisers may already have in place some or all of the required compliance systems. However, significant time may be required to create an internal consensus on the appropriate policies that should be in place and to build the necessary infrastructure to implement and monitor those systems.

Common areas where managers may be required to enhance their compliance infrastructure include the following: books and records required to be maintained under the Advisers Act; developing procedures to ensure the privacy of client information; creating redundant systems in the event of a business interruption; email back-up, retention and surveillance systems; and implementing procedures to monitor personal trading.

Creating the implementation team: There are many law firms and compliance consultants who can help managers with this process. However, these professionals cannot substitute for the internal team that must be assembled to implement this initiative. Depending on the size of the organisation, back office and accounting, marketing, client service, technology, trading and portfolio management personnel must all be involved.

Despite the recent appointment of a new SEC chairman, it is highly likely the Rule will go into effect as planned on 1 February 2006. Continuing delay will jeopardise the ability of a manager to come into compliance with the Rule by the deadline, exposing the manager's business to considerable regulatory risk.