

SEC's Final Rules Requiring Registration of Investment Advisers to Hedge Funds

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On December 2, 2004, the Securities and Exchange Commission ("SEC") issued a new rule and amendments under the Investment Advisers Act of 1940 ("Advisers Act"). The amendments require certain hedge fund advisers to register with the SEC by February 1, 2006. A summary of the new rule and amendments is discussed below.

Background

The Advisers Act governs the activities of investment advisers, including hedge fund managers, subjecting them to certain regulatory requirements including: (i) registration with the SEC; (ii) maintenance of certain business records; (iii) delivery of a disclosure statement to clients; and (iv) satisfaction of fiduciary duties to clients. The Act provides an exemption from registration, however, for investment advisers who have fewer than 15 clients, do not hold themselves out to the public as investment advisers and do not act as advisers to a registered investment fund.² Investment advisers are also exempt from SEC registration if they have less than \$25 million of assets under management. In addition, a safe harbor provision, adopted by the SEC in

1986, permitted hedge fund managers to count each hedge fund as a single client. Hedge fund advisers managing 14 or fewer hedge funds were, therefore, generally exempt from registration under the Advisers Act. Under the new rule and amendments, however, investment advisers must now "look through" the funds and count each of the underlying investors as a single client. Accordingly, as discussed more fully below, the new rule will require most hedge fund managers to register with the SEC by eliminating the ability to count each hedge fund as a single client for purposes of the private adviser exemption.

The New Rule And Amendments

Under new Rule 203(b)(3)-2, investment advisers may no longer count a "private fund" as a single entity. Rather, each owner of a "private fund" counts towards the 14-client threshold of the private adviser exemption.³ Investment advisers, therefore, must "look through" each "private fund" and count each shareholder, limited partner member or beneficiary of a "private fund" as a client. The investment adviser itself, however, and certain knowledgeable employees

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2 Section 203(b)(3) of the Advisers Act and Rule 203(b)(3)-1.

3 Under the new rule, a "private fund" is an entity that has all of the following characteristics: (i) the fund is exempt from the definition of "investment company" under sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940; (ii) the fund permits investors that invest in the fund on or after February 1, 2006 to redeem their interests in the fund within two years (although the rule permits funds to offer redemption rights under extraordinary circumstances and provide interests acquired through reinvestment of distributed capital gains or income without being considered a "private fund"); and (iii) the funds' interests are offered based on the investment advisory skills, ability or expertise of the investment adviser.

who are deemed “qualified clients” can be excluded as clients. Thus, an investment adviser may no longer avail itself of the private adviser exemption and must register with the SEC if, during the course of the preceding 12 months, the total number of the adviser’s individual clients and investors in its “private funds” is 15 or more.

In addition, investment advisers must also “look through” and count the owners of any fund of funds that is itself a “private fund.” Furthermore, offshore hedge fund managers must “look through” any “private fund” they manage and count each underlying U.S. resident as a client for purposes of the 14-client threshold.⁴

The new rules adopted by the SEC do not affect the general rule that an adviser must have at least \$25 million in gross assets under management in order to be eligible to register with the SEC. Offshore advisers, however, must register with the SEC regardless of the size of their assets under management. An investment adviser who does not meet the minimum asset requirements to register with the SEC must follow state law to determine whether registration is required within its state.

Other related amendments to the Advisers Act include:

(i) The Recordkeeping Rule:⁵ Investment advisers that are required to register with the SEC may market their performance for peri-

ods prior to their registration even if they have not retained all of the required records. In addition, registered investment advisers must maintain books and records of the “private funds” for which they act as investment advisers, general partners, managing members or in similar capacities.

(ii) The Performance Fee Rule:⁶ The new rule provides an exemption from the general prohibition on performance fees and allows a registered investment adviser to charge a performance fee for “qualified clients,” *i.e.*, clients having a net worth of more than \$1.5 million or at least \$750,000 assets under management with the adviser.

(iii) The Custody Rule:⁷ The amended custody rule affords advisers of funds of hedge funds additional time to complete audit work for distributing financial statements for the audited funds. The distribution deadline has been extended from 120 to 180 days from the end of the fund’s fiscal year. In order to qualify for the extension, the fund of funds must invest 10 percent or more of its total assets in other unrelated pooled investment vehicles.

(iv) Form ADV: The SEC has amended Form ADV to require advisers of “private funds” to identify themselves as hedge fund advisers. Advisers must amend their Form ADV to incorporate this revision by February 1, 2006.

4 The new rule contains special provisions to limit the extraterritorial application of the Advisers Act to offshore advisers of offshore funds with U.S. clients. An offshore adviser to an offshore fund will not be subject to most of the substantive provisions of the Advisers Act with respect to such a fund. Such an adviser, however, would be required to: (i) register with the SEC if its “private funds” have 15 or more U.S. clients on a “look through” basis; (ii) keep certain books and records; and (iii) remain subject to examinations by the SEC.

5 Rule 204-2 under the Advisers Act.

6 Rule 205-3 under the Advisers Act.

7 Rule 206(4)-2 under the Advisers Act.

8 Electronic filing of the Form ADV is required unless: (i) you have been granted a continuing hardship exemption from the SEC or a State securities authority that requires electronic filing; or (ii) you are filing with a State securities authority that does not require electronic filing.

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Compliance

Hedge fund managers are required to comply with the new rule and new amendments by February 1, 2006. By that date, each hedge fund manager required to register as a result of the SEC's rulemaking actions must have: (i) completed and electronically filed⁸ the Form ADV registration statement with the SEC using the Investment Adviser Registration Depository internet website (www.iard.com);⁹ (ii) secured an effective registration; and (iii) be in compliance with all applicable requirements under the Advisers Act, including, among other things:

- adopting policies to prevent misuse of material nonpublic information;
- adopting policies to ensure securities are voted in the best interest of the client;
- adopting a Code of Ethics that addresses conflicts of interest and policies regarding personal trading in securities;
- having a compliance manual in place as soon as it is registered with the SEC;
- designating a Chief Compliance Officer who is competent and knowledgeable with respect to securities laws; and

- maintaining accounting records, advisory records and personal trading records for a period of five years.

In addition, hedge fund managers required to register with the SEC must electronically file an annual updating amendment to their Form ADV within 90 days after the end of their fiscal year. The hedge fund manager is required to submit an execution page with its initial application for SEC registration, as well as with any and all amendments to the registration, certifying that the information contained therein is true and correct and that the adviser's books and records will be preserved and available for inspection by the SEC.¹⁰

To view a copy of the SEC's final rule and amendments, see:

<http://www.sec.gov/rules/final/ia-2333.pdf>

This Client Advisory is a summary for general information and discussion only. It is not a complete analysis of the matter presented and may not be relied upon as legal advice which may often turn on specific facts. Readers should seek legal advice before acting with regard to the matters mentioned herein.

9 A paper version Form ADV can be downloaded from the SEC's internet website at: <http://www.sec.gov/divisions/investment/iard/iastuff.shtml>

10 A copy of the paper version execution page for domestic investment advisers is attached. Paper version execution pages for State-registered investment advisers and non-resident investment advisers can be downloaded from the SEC's internet website at: <http://www.sec.gov/about/forms/formadv.pdf>