NEW SEC RULE REQUIRES REGISTRATION FOR MOST HEDGE FUND ADVISERS

In response to rapid growth in the number and size of hedge funds, increasing direct and indirect participation of "retail" investors and significant recent regulatory enforcement actions involving hedge funds, the SEC, by 3-2 vote, changed the client counting rule under the Investment Advisers Act of 1940 (the "Advisers Act"), so that most hedge fund advisers must register with the SEC as investment advisers by February 1, 2006 (i.e., 13 months from now).[1]

The new rules apply only to an adviser to one or more "private funds," narrowly defined to cover only funds which allow investors to redeem interests within 2 years after purchase, thus generally covering hedge fund advisers, but not advisers to private equity and venture capital ("PE/VC") funds.

Special rules apply to offshore advisers.

New Definition of "Private Fund"

Most advisers to hedge funds and other private funds are currently exempt from SEC investment adviser registration under the fewer-than-15-client exemption, under which an adviser need not register if it (1) advises fewer than 15 clients during a 12 month period, (2) does not hold itself out generally to the public as an investment adviser, and (3) does not serve as adviser to a registered investment company or business development company.

Since 1985, advisers have been expressly permitted by SEC rule to treat a pooled investment entity as one client, rather than counting each underlying investor in the entity, so long as the adviser's management of the entity is based on the entity's investment objectives rather than the individual objectives of the entity's investors.

The newly adopted Advisers Act rule requires that an adviser to a "private fund" must count each underlying investor (other than its knowledgeable employees) for purposes of the fewer-than-15-client exemption. For those purposes "private fund" is defined as a fund that:

- avoids investment company registration by relying on §3(c)(1) or §3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act"),[2] and
- permits investors to redeem any portion of their ownership interest within 2 years after purchase.

This "private fund" definition is intended to exclude PE/VC funds and other pooled entities requiring long-term capital commitments. The SEC explained its differing treatment of hedge funds and PE/VC funds by noting (1) the redemption feature of most hedge funds provides each investor a short-term right to withdraw assets from the adviser's management based on the investor's individual liquidity needs and other preferences similar to a separate account relationship, which historically counts each account owner and (2) the lack of significant enforcement problems concerning PE/VC fund advisers.

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[1] The SEC generally requires an adviser to have at least $25 million under management in order to qualify for federal registration, with smaller advisers generally subject to state regulation.

[2] A private fund relying on §3(c)(1) is limited to 100 beneficial owners and may not make a public offering of securities. A private fund relying on §3(c)(7) may have more than 100 beneficial owners, but is limited to "qualified purchasers" (e.g., an individual with investments of at least $5 million or an entity with investments of at least $25 million) at the time of purchase and may not make a public offering of securities.

In determining whether a fund allows redemptions within 2 years:

- An extraordinary redemption does not count as a redemption, including redemptions due to: (1) impractical or illegal continued holding of the investment by the investor, (2) death or disability of the investor, (3) death or certain events for key personnel of the adviser, (4) a fund merger or reorganization, or (5) a materially adverse tax or regulatory outcome from continued holding of the investment by the investor.

- Distributions initiated by the adviser payable to all investors or classes of investors in accordance with a fund's governing documents do not count as a redemption.

- An investor's transfer of an interest in a fund to a new investor in a secondary market transaction does not count as a redemption.

- The 2 year period is calculated from the date of each acquisition of an investment (other than acquisition through reinvestment of distributed capital gains or income) and use of a first-in first-out calculation is permissible.

- A side letter permitting a shorter than 2 year redemption period for one or more investors causes a fund to be a private fund.

Related Amendments to Performance Fee, Recordingkeeping and Custody Rules

Performance Fees. Currently, a registered investment adviser may not charge a performance fee or carried interest to any investor in a §3(c)(1) fund unless the investor is a "qualified client" (i.e., generally has at least $1.5 million net worth or $750,000 invested in the fund and/or with the adviser).

The amended rule permits an adviser registering due to the new client counting rules to continue collecting performance fees or carried interest from an investor in a §3(c)(1) fund that does not meet the qualified client standard, if such investor originally invested in the fund prior to February 10, 2005. After February 10, 2005 (i.e., a year prior to required registration), any new investor that does not meet the qualified client standard is not covered under this grandfathering provision, so the adviser is not permitted to charge the investor a performance fee following registration with the SEC.

The amendment also permits an adviser required to register under the new rule to continue to charge performance fees under investment advisory contracts entered into with clients other than §3(c)(1) funds, such as separate accounts, prior to February 10, 2005.

Use of Prior Performance and Recordkeeping. Currently, a registered investment adviser is required to keep certain records to support its calculation of any prior performance.[3]

The SEC amended the recordkeeping rule to permit an adviser required to register by the new rule to use its prior performance for periods ending prior to February 11, 2005 without the supporting documentation required by the Advisers Act. An adviser to a private fund planning to use prior performance after registration must comply with the recordkeeping requirements related to calculation of prior performance for periods ending after February 10, 2005 (i.e., a year prior to required registration).

The recordkeeping amendment applies not only to the performance records of a private fund, but also permits continued use of prior performance of other funds and accounts managed by the adviser, such as PE/VC funds or composite performance for separate accounts.

Form ADV. The SEC amended Form ADV to require an adviser to identify itself as a private fund adviser and provide certain additional information (generally already required for registered advisers sponsoring private investment entities), including:

- the number and name of private funds or other pooled entities managed by the adviser or its related persons,

- whether clients are solicited to invest in such private funds or pooled entities,

- the minimum investment in such private funds or pooled entities,

[3] These records include all accounts, books, internal working papers and any other records or documents necessary to form the basis for or demonstrate the calculation of prior performance.

- the percentage of the adviser's clients investing in such private funds or pooled entities, and
- the minimum investment commitment required in such private funds or pooled entities.

Custody Rule and Distribution of Audited Financial Statements. Although not directly related to the new rule requiring private fund adviser registration, in connection with the new rule and in response to requests for relief, the SEC amended the custody rule to allow additional time for a fund of funds[4] adviser to distribute audited fund financial statements to investors to comply with the Advisers Act custody rule. A fund of funds adviser is allowed 180 days from the end of the fund's fiscal year to distribute audited fund financial statements, as opposed to 120 days for other funds. This custody rule amendment applies to all pooled investment entities meeting the definition of a fund of funds, including those investing in PE/VC funds.

Offshore Advisers and Funds

The new rules seek to provide U.S. investors with the same general level of Advisers Act protection regardless of the country in which an adviser is located. Accordingly, an offshore adviser is subject to the same (look through) client counting rule for U.S. investors as a domestic adviser.

An offshore adviser is required to look through each private fund advisee,[5] whether the fund is organized offshore or in the U.S., and count solely U.S. resident investors as clients for purposes of the fewer-than-15-client exemption. An investor's residency is determined at the time of investment, so that a non-U.S. resident at time of investment continues to count as non-U.S. even if the investor subsequently relocates to the U.S.

The scope of Advisers Act regulation is limited for an offshore adviser required to register by the new rules, with the registered offshore adviser subject to the anti-fraud provisions of the Advisers Act, limited recordkeeping requirements and SEC examinations. However, any such registered offshore adviser is not subject to other detailed Advisers Act requirements, such as the compliance program rule, custody rule, proxy voting rule and code of ethics rule (but must retain the personal securities reports of access persons that would otherwise be required under a code of ethics).[6]

Alter Ego Registration Requirements

The sponsor of a pooled investment entity not meeting the new definition of a private fund (e.g., a PE/VC fund sponsor) with an affiliate that advises a private fund should be aware that the registration of an affiliated entity may require affiliated advisers (e.g., PE/VC fund general partner or manager) to register under the SEC's alter ego analysis.

This analysis focuses on the separateness of the affiliated advisers, and makes the fewer-than-15-client exemption from registration potentially unavailable to certain affiliates of a registered investment adviser if not sufficiently separate and distinct from the registered adviser. In conducting this analysis, the SEC generally focuses on the separateness between the management, investment personnel and investment processes of the affiliated advisers.

Future Implications for PE/VC Fund and Other Pooled Investment Entity Sponsors

In the adopting release, the SEC stated explicitly that the new rules are not designed to apply to advisers to PE/VC funds or sponsors of other static pooled investment entities and that this differing regulatory approach for hedge funds will allow the SEC to focus its examination resources on advisers to hedge funds rather than on advisers to PE/VC funds "at this time." Although there is no reason to believe that the SEC intends to extend registration requirements to PE/VC fund sponsors or sponsors of other static pooled entities not covered by the new rules, the SEC may revisit the issue in the future. As part of its rationale for requiring the registration of advisers to hedge funds, the SEC noted that the intent of Congress in enacting the fewer-than-15-client exemption was to create a limited exemption for advisers with activities that are not national in scope who provide advice to only

4 A fund of funds is defined as a pooled investment entity that invests 10% or more of its total assets in other pooled investment entities not advised by a related person.

5 The new rule excludes from the private fund definition an offshore publicly offered investment company (other than a hedge fund) located, regulated as a public investment entity, and publicly offering its securities outside the U.S.

6 A registered offshore adviser required to register by the old rules is generally subject to the detailed Advisers Act requirements with respect to such U.S. clients.

a small number of clients, many of whom are friends and family. As noted by the dissenting SEC Commissioners, this rationale applies equally to advisers to PE/VC funds or other static pooled investment entities, yet these advisers are still permitted to rely on the fewer-than-15-client exemption.

Key Effective Dates and Compliance Dates

Important compliance and effective dates for the new rules and all related amendments are:

- January 10, 2005: Custody rule and Form ADV amendments are effective.
- February 10, 2005: In anticipation of SEC investment adviser registration by February 1, 2006, private fund advisers should:
  - implement formalized prior performance recordkeeping, and
  - admit only qualified client investors to private funds and any PE/VC fund or other pooled entity sponsored by the private fund adviser.
- February 1, 2006: Private fund advisers not meeting the revised fewer-than-15-client exception must be registered with SEC.

Should you have any questions about the matters addressed in this issue of the Investment Management Alert, please contact the following Kirkland & Ellis authors or the Kirkland & Ellis attorney you normally contact.

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