US legal and regulatory developments

Registration under the Investment Advisers Act of 1940 of certain hedge fund advisers

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OVERVIEW

In December 2004, the US Securities and Exchange Commission (SEC) issued a new rule and related rule amendments (collectively, the Rule) under the Investment Advisers Act of 1940 (Advisers Act) that will require many investment advisers to hedge funds to register with the SEC. If registration is required, advisers will need to do so by 1st February, 2006.

The SEC lists a number of reasons for adopting the Rule. Among them are the growth in size and number of hedge funds, an increase in the number of enforcement actions resulting from advisers having defrauded hedge fund investors and the broadening of the investor base for hedge funds beyond its traditional group of wealthy individuals and families. Neither the SEC nor any other government agency has collected information specifically on hedge funds. As a result, the SEC has acknowledged that its ability to protect investors is handicapped, because it is unable to detect fraud cases early on. It is also unable to prevent unfit persons or wrongdoers from entering the market. The development of a market for 'funds of hedge funds' also caused concern for the SEC. It stated that such entities made investing in hedge funds more broadly available to investors. Taken together, these factors have led the SEC to state that the current regulatory regime for hedge fund advisers is inadequate.[1]

An investment adviser is defined under the Advisers Act as 'any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities'.[2]

Persons falling within the scope of this definition are required to register as investment advisers with the SEC. Registration is not required if an exemption is applicable, however. Before the Rule, hedge fund managers relied on the exemption at Section 80b-3(b)(3) of the Advisers Act. This exemption, known as the 'private adviser exemption', provides that an investment adviser located in the USA is not subject to the registration requirements of the Advisers Act if, during the course of the previous 12 months, it has had fewer than 15 clients and neither holds itself out generally to the public as an investment adviser nor acts as an adviser to a registered investment company.

Exemption from registration allows advisers rightly to avoid compliance with the provisions of the Advisers Act applicable to registered managers. These provisions impose various obligations on registered advisers, including the development of compliance policies, the naming of a chief compliance officer, the adoption of a code of ethics, certain recordkeeping obligations, the filing of a Form ADV and adhering to certain custody and performance fee rules, it also subjects the registered investment adviser to periodic inspections. Note that hedge fund advisers who are not required to register are, nevertheless, subject to the anti-fraud and market manipulation provisions of the Advisers Act.[3]

It is important to note that the Rule does not affect other exemptions from registration available to hedge fund advisers. If one of those exemptions is still applicable to the hedge fund adviser, registration is not required. The changes brought about by the Rule, however, will require most hedge fund managers to register, as the requirement of having to count each owner of an interest in a hedge fund as a client for the purposes of the private adviser exemption will mean that most will be unable to benefit from this exemption.

PRIVATE ADVISER EXEMPTION

As outlined above, any investment adviser located in the USA who, during the course of the preceding 12 months, has had fewer than 15 clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any registered investment company is exempt from registration under the Advisers Act.

For purposes of this exemption, Rule 203(b)(3)-1 provides, in the relevant part, that a corporation, general partnership, limited partnership, limited liability company, certain trusts or other legal organisation that receives investment advice based on its own investment objectives, rather than on the individual investment objectives of its shareholders, partners, limited partners, members or beneficiaries, shall be deemed a single client. This rule providing a safe harbour was adopted by the SEC in 1985 and was expanded to add additional types of entities that advisers use to pool client assets. As a result of this rule, the Commission stated that the private adviser exemption currently permits advisers to avoid registration, even though they administer large amounts of client assets and, indirectly, have a great number of clients. It is thus inconsistent with the original purpose of the registration exemption in Section 203(b)(3), which was designed merely to exempt advisers whose business was too limited to justify regulatory attention.[4]

THE RULE — 'PRIVATE FUND'

The Rule now provides that an adviser may no longer count a 'private fund' as a single client. The Rule requires advisers to 'look-through' a private fund to count each owner of an interest or share in these funds as a client for the purposes of the 15-client threshold.

A 'private fund' is defined as a company: (i) that would be an investment company under Section 3(a) of the Investment Company Act of 1940 but for the exception provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of such Act; (ii) that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and (iii) the interests in which are, or have been, offered based on the investment advisory skills, ability or expertise of the investment adviser.

In addition, investment advisers will also be required to look through any fund of funds that is itself a private fund and count the ultimate beneficial owners of the 'top tier' fund of funds as a single client. Under the Rule, an investment adviser to the lower tier private fund is required to know neither the identities of the investors in the top tier private fund nor the exact number of investors. Neither does the Rule specify how often or at what times such an adviser is required to assess whether the number of ultimate investors or owners exceeds 14, so long as it is able to determine on a periodic ongoing basis its own registration requirements.

The first clause of the definition of 'private fund' serves to exclude business organisations, including insurance companies, broker-dealers and banks, from the 'look-through' requirement. Most attention will probably focus on the second clause of the definition of 'private fund'. The requirement to make a long-term commitment of capital is one feature that distinguishes hedge funds from other unregistered investment vehicles. With this provision, the SEC sought to exclude advisers to private equity funds, venture capital funds and similar funds that require investors to make a long-term investment. These investments typically have a lock-up period in excess of two years, during which time investors are not permitted to redeem their investments. This provision is also designed to exclude certain structured finance vehicles from being caught by the 'private fund' definition.[5] The lock-up requirement is considered in greater detail below. Finally, the third requirement is one characteristic that is important to investors. In deciding whether to invest in a particular hedge fund, its adviser's history, demonstrated expertise, strategies and disciplinary record are probably germane to that decision and, accordingly, hedge funds often highlight the adviser's record and provide relevant information regarding the adviser.

LOCK-UP PERIOD

As noted above, the Rule includes in the definition of 'private fund' funds that allow investors to redeem capital contributed to the fund within two years of their investment. The provision applies to each interest purchased or amount of capital contributed. The SEC has stated that hedge funds may use a 'first in, first out' methodology to determine the age of purchases and contributions.[6]

A fund will not be a private fund under the Rule solely because it permits owners to redeem their interest in extraordinary circumstances within the two-year lock-up period.[7] The SEC views these redemption rights as not changing the fundamental nature of the investment vehicle. As such, the SEC gave certain examples of 'extraordinary' circumstances where redemption would be permitted. These examples are: (i) where holding the investment becomes impractical or illegal; (ii) when an owner dies or suffers a total disability; (iii) when key personnel at the adviser die, are incapacitated, or cease to be involved in the management of the fund for an extended period of time; (iv) a merger or reorganisation of the fund; or (v) avoiding a materially adverse tax or regulatory consequence of the investment.[8]

In addition, a hedge fund may not use a side letter agreement to circumvent the two-year lock-up requirement and provide a limited number of investors with enhanced liquidity rights.[9]

Finally, distributions by a hedge fund are not restricted by the Rule. Distributions payable to all owners, or a class of owners, in accordance with the fund's organisational documents are distinguished from redemptions initiated by an investor.[10] Likewise, a transfer by an owner's interest in the secondary market to another partner or investor will not be considered a redemption, and interests acquired through reinvestment of distributed capital gains or income are also excluded from the two-year redemption limitation.[11]

DETERMINING THE NUMBER OF CLIENTS

In making its determination of the number of clients that must be included in the tally, a hedge fund adviser will be guided, as is the case today, by the other provisions of Rule 203(b)(3)-1. There is no requirement to include any non-paying client to whom the adviser provides investment advice. An investment adviser may also exclude itself from the count as well as certain knowledgeable advisory personnel who are 'qualified clients'. A 'qualified client' is defined in Rule 205(3)(d)(1)(iii).[12]

OFFSHORE ADVISERS

Setting aside suggestions by commentators to exempt from regulation offshore advisers if they are subject to regulation in their home jurisdiction, the SEC has made the new counting rules applicable to 'offshore' advisers. Whether an adviser is offshore depends on its principal office and place of business.[13] As it applies to offshore advisers, the Rule does not require an offshore adviser to count non-US resident clients for the purposes of the 14 client threshold. To determine residency in this instance, the SEC has suggested that, until it reconsiders this question, it will not object if an adviser looked: (i) in the case of individuals, to their residence; (ii) in the case of corporations and other business entities, to their principal office and place of business; (iii) in the case of personal trusts and estates, to the rules set out in Regulation S; and (iv) in the case of discretionary or non-discretionary accounts managed by another investment adviser, to the location of the person for whose benefit the account is held.[14] The investment adviser is only required to make the determination of residency at the time of investment in the private fund.[15]

The Rule does include an exception from the definition of 'private fund'. It is found in Rule 203(b)(3)-1(d)(3), which states, in the relevant part, that: 'A company is not a private fund if it has its principal office and place of business outside the US, makes a public offering of its securities in a country other than the United States, and is registered as a public investment company under the laws of the country other than the United States'. This exception applies to publicly offered funds, regardless of type.

The Rule is also limited in its extraterritorial application. An offshore adviser that provides investment advice to an offshore private fund is not required to count the investors in the private fund but, instead, may count only the private fund (for most purposes of the Advisers Act). In addition, such an offshore adviser is not subject to all the requirement of the Advisers Act. Although the offshore adviser is subject to the registration requirement (unless an exception is available to it) and certain recordkeeping requirements and also remains subject to examination by the SEC staff, it is not subject to the Advisers Act compliance rule, the custody rule and proxy voting rule.[16]

RECORDKEEPING REQUIREMENTS

Two amendments to the recordkeeping requirements were introduced by the Rule. The first provides transitional relief for investment advisers not previously required to register under the Advisers Act. The second clarifies that, for purposes of Section 204 of the Advisers Act, the books and records of a registered investment adviser include the records of the private funds for which the adviser acts as investment adviser and the adviser or related person (as referenced in Form ADV) acts as general partner, managing member or in a similar capacity.

The recordkeeping obligations set forth at Rule 204-2 require a registered investment adviser to maintain supporting documents regarding its track record and performance information used in advertising material circulated or distributed, directly or indirectly, to ten or more persons for a period of five years after the performance information was last used. The transitional rule in the Rule provides that a registered investment adviser that was exempt from registration prior to 10th February, 2005, under section 203(b)(3) of the Advisers Act, is not required to maintain books and records that would otherwise be required to be maintained under the recordkeeping rule for the period prior to such date. It is, however, required to keep the information that it already has maintained so far. The general rule applies to all private fund advisers as of 10th February, 2005.

PERFORMANCE FEE

Under the Advisers Act, investment advisers are prohibited from charging performance fees to clients unless they are a 'qualified client'. A 'qualified client' under Rule 205-3 generally includes a natural person or a company that has at least $750,000 under the management of the investment adviser, or either has a net worth of $1,500,000 or is a 'qualified purchaser' (as defined in the Investment Company Act of 1940 (the Investment Company Act)[17]). The SEC has recognised that fund advisers that were previously unregistered may have clients that do not satisfy this standard. Thus, the SEC has grandfathered existing relationships by amending Rule 205-3 so that the adviser can still change performance fees to those clients who were clients of the fund prior to 10th February, 2005, who would not otherwise be qualified clients. These clients may also add to their investments.

FINANCIAL REPORTING AND THE CUSTODY RULE

Rule 206(4)-2 has been amended to allow advisers to 'funds of funds' that opt to distribute audited financial information to investors under the custody rule more time to complete their audit work. Acknowledging that it was difficult for advisers of funds of funds to comply with a 120-day deadline because they had been unable to obtain the requisite audits from the underlying funds to complete their own audits, an additional 60 days was added to the compliance period. Now advisers to funds of funds have 180 days in which they may distribute audited financial statements under the custody rule. A fund of funds is defined as 'any limited partnership (or limited liability company, or other type of pooled investment vehicle) that invests 10 per cent or more of its total assets'[18] in other unrelated pooled investment vehicles.

FORM ADV

Form ADV has also been amended to require investment advisers of private funds to identify themselves as advisers.

COUNTING CLIENTS FOR STATE REQUIREMENTS

It was not the SEC's intention to alter the method of counting clients for other purposes, and Rule 222-2 and Rule 203(b)(3)-1 were amended to clarify that, for the purposes of those rules, advisers may count clients without applying the 'look-through' methodology introduced into the Advisers Act. Section 222(d) of the Advisers Act provides, in the relevant part, that a state may not require an adviser to register with its state authority unless the investment adviser has a place of business in the state or has had (during the 12 months preceding any date of determination) at least six clients that are residents of that state. The amendments make clear that an adviser is not required to count clients on a 'look-through' basis for the purposes of the national *de minimis* standard in Section 222(d) and for the purposes of the definition of 'investment adviser representative' in Rule 203A-3.

REGISTRATION THRESHOLDS

The Rule does not change the eligibility requirements for registration under the Advisers Act. An investment adviser whose principal place of business is in the US may not register with the SEC under the Advisers Act unless it has at least $25m under management. Additionally, if it has $30m or more under management, it must register with the SEC, unless it benefits from a registration exemption. These thresholds have not changed. An investment adviser need include neither proprietary assets invested in the fund nor the amount invested by non-US investors in making these determinations. Also, an offshore investment adviser must register with the SEC if it has 15 clients (or more) who are residents of the US, regardless of the dollar amount of the assets managed. Investment advisers must also take note of any state registration requirements if they are not required to register with the SEC. Indeed, registration with the state authority may be mandated by the laws of a US state in certain circumstances.

COMPLIANCE DATES

Hedge fund advisers are required to comply with the Rule by 1st February, 2006.[19] This is the general date for compliance. By this date, registration with the SEC must be effective and the adviser must also satisfy the other requirements of the Advisers Act by having the necessary policies and procedures in place. For example, a compliance officer must have been named by such date.[20]

COMMENTS

It is interesting to note that the SEC's authority under the Advisers Act to adopt the Rule was challenged by a few commentators. The Release outlines in detail the basis upon which the SEC grounds its right to introduce these amendments, arguing that the Advisers Act has given it broad rulemaking authority.

The SEC argued in the Release that the Rule will benefit investors in private funds, clients of investment advisers and investment advisers themselves to an extent greater than the potential costs of compliance. Deterring fraud and the reduction of any losses resulting from fraud; providing basic information about hedge fund managers; improved compliance controls and knock-on benefits for mutual fund investors, market participants and regulatory policy; as well as a level playing field for all investment advisers were cited as benefits of the Rule. Whether these benefits and the increased confidence in the system are outweighed by the costs of compliance, including the registration cost, costs of creating a compliance infrastructure and ongoing compliance expenditures, remains to be seen.

This legal and regulatory round-up is not intended to be a comprehensive guide to the subject matter it covers, or to provide legal advice. For further information, please contact Ian Cuillerier at Hunton & Williams: icuillerier@hunton.com

References

1 See *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, SEC Release No. IA-2333, 69 Fed. Reg. 72054 (10th December, 2004) available at the SEC's website at www.sec.gov/rules/ (the 'Release).
2 Section 202 (a)(11) of the Advisers Act.
3 Section 206 of the Advisers Act.
4 See Release at 72055 and 72065.
5 See Release at footnote 234.
6 See Release at footnote 231.
7 See Release at 72074 and Rule 203(b)(3)-1(d)(2)(i).
8 See Release at footnote 240.
9 See Release at footnote 233.
10 See Release at footnote 241.
11 See Release at 72075 and Rule 203(b)(3)-1(d)(2)(ii).
12 The SEC notes that an adviser could not make a private fund investor a partner in the advisory firm to avoid counting the investor for purposes of the 14 client limit. See Release at footnote 194.
13 See Rule 203(b)(3)-1(b)(5).
14 See Release at footnote 201.
15 See Rule 203(b)(3)-1(b)(7).
16 See Release at 72072 and 72973.
17 15 USC. 80a-2(a)(51)(A).
18 See Rule 206(4)-2(c)(4).
19 The custody rule amendment was effective on 10th January, 2005. The Form ADV amendments became effective on 10th January, 2005, but the changes to the IARD filing system only incorporated those changes on 8th March, 2005.
20 Rule 206(4)-7. Also see Rule 206 generally.