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NEW SEC RULE TAKES AIM AT HEDGE FUND AND OTHER PRIVATE FUND ADVISERS

The SEC recently adopted new rule 203(b)(3)-2 (the “New Rule”) requiring investment advisers of many hedge funds to register with the SEC under §203(a) of the Investment Advisers Act of 1940 (the “Advisers Act”). Although the New Rule is aimed primarily at hedge fund advisers, it also applies to many forms of “private funds” (*i.e.*, 3(c)(1) and 3(c)(7) funds). Therefore, anyone who gives investment advice to such funds for compensation – whether as an investment adviser or in any other capacity such as general partner – should review the New Rule. This newsletter summarizes the New Rule and related amendments to other SEC Rules.

Before the New Rule. Prior to the New Rule, advisers to “private funds” were exempt from registration under the Advisers Act if, among other things, they advised fewer than 15 clients during the preceding 12-month period. For purposes of this test, the SEC generally permitted advisers to count each fund they advised as a single client, regardless of the number of individual investors in the fund.

New Counting Method. The New Rule changes the client-counting method where a “private fund” both (a) is offered based on the advisory expertise and ability of the investment adviser, and (b) permits redemption within two years of purchase. Any fund meeting both of these criteria is deemed a “Private Fund” under the New Rule, and each individual investor in a Private Fund counts as a separate client.

Applying the New Counting Method. Adviser X has 5 fund clients. Assume that each client is a Private Fund and that each has 10 individual investors. Under the New Rule, Adviser X will have a total of 55 clients (5 Private Funds plus 50 individual investors). This takes Adviser X well outside the 15-client exception. A similar counting method applies if any of an adviser’s *fund* clients – whether public or private – is a “Fund of funds” (*i.e.*, a fund that invests in other funds). For example, assume that Adviser Y has only one client – a Private Fund client which has 5 investors including one “Fund of funds”. The “Fund of funds” has 25 investors. Under the New Rule, Adviser Y will have a total of 31 clients.

Deadline to Comply with New Rule. Although the New Rule takes effect as of February 10, 2005, newly covered advisers are not required to register with the SEC until February 1, 2006. However, investment advisers who find themselves required to register will need to begin to comply with certain Advisers Act requirements immediately, including rules relating to the maintenance of books and records.

Effect of Registration. Registration with the SEC requires an adviser to complete and file Form ADV and to: (i) keep accurate books and records, (ii) adopt and implement written proxy voting policies and procedures, (iii) adopt and implement compliance policies and procedures (including the designation of a chief compliance officer), (iv) establish and implement a written code of ethics, and (v) meet certain client disclosure obligations which include disclosure of certain material events and delivery of a disclosure statement that meets certain requirements to all clients and prospective clients. In addition, current proposed rules – if adopted – would require advisers to adopt anti-money laundering programs and customer identification procedures. The SEC generally audits advisers within one year of initial registration to confirm compliance with the foregoing duties and retains the right to inspect any adviser’s records at any time.

A person that fits the definition of “investment adviser” and that is not otherwise exempt from registration (as described below) must register either with the SEC or with each individual state where the person conducts advisory business, depending on the amount of assets the person has under management (“AUM”). If an adviser has AUM under \$25 million and no reasonable expectation of reaching that amount within 120 days, state registration is the only option. If the adviser has AUM between \$25 million and \$30 million, the adviser may elect either state or federal registration. If the adviser has AUM of \$30 million or more, SEC registration is the only option. The New Rule has not changed the monetary thresholds for adviser registration.

The Two-Year Redemption Test. Under the New Rule, a fund that establishes a lock-up period that prohibits redemption during the first two years after purchase is not a Private Fund. Some funds may wish to impose a two-year lock-up period to avoid Private Fund status. However, any fund considering this approach needs to understand the following aspects of the two-year redemption test.

- **First in, First out.** The test applies separately to an investor’s initial investment in a fund and each subsequent investment made by that investor in the same fund. Each investment needs to remain in the fund for two full years. Exempt from the two-year redemption test are distributions initiated by the fund’s adviser and interests in the fund acquired with reinvested dividends.

- *Investments Subject to Test.* Only investments made on or after February 1, 2006 are subject to the test.

Extraordinary Circumstances. If there are circumstances involving “events found after reasonable inquiry to be extraordinary,” a fund may permit redemption within two years and still avoid “Private Fund” status. Examples of such events may include: “key person” events (*e.g.*, death of the primary adviser), material adverse tax or regulatory events, events that could cause an investment to become “impractical or illegal,” and personal events (such as an investor’s death or disability). Beware that the SEC interprets this “extraordinary circumstances” exception strictly and narrowly.

Offshore Advisers. The New Rule requires advisers located outside the U.S. to “look through” their Private Fund clients and count each investor that is a U.S. resident as a separate client. “Residence” means: (a) for an individual, his/her principal residence, (b) for an entity such as a corporation, its principal office, (c) for a personal trust or estate, the place designated in the rules of Regulation S of the Securities Act of 1933 (which governs private offshore securities offerings) and (d) in the case of a discretionary or non-discretionary account managed by another adviser, the location of the person for whom the account is held.

An offshore adviser is not required to “look through” a Private Fund located outside the U.S., provided that the offshore Private Fund: (i) has its principal office outside the United States, (ii) makes a public offering of securities outside the United States, and (iii) is regulated as a public investment company under the laws of a country other than the United States.

Unlike domestic advisers, an offshore adviser that registers with the SEC is exempt from some Advisers Act requirements. For example, an offshore adviser is not required to adopt a code of ethics or proxy voting procedures. In addition, an offshore adviser is not subject to Advisers Act restrictions on performance fees or rules pertaining to custody of client funds.

Amendments to other Advisers Act Rules in connection with the New Rule.

- *Rule 204-2.* The rule as amended provides that all advisers that register pursuant to the New Rule will need to comply with the Advisers Act recordkeeping requirements for all periods ending after February 10, 2005. In addition, the amended rule clarifies that the Advisers Act recordkeeping requirements apply not only to the adviser’s own books and records but also to the books and records of the adviser’s Private Fund clients, plus any Private Funds for which the adviser or an affiliate of the adviser acts as general partner, managing member, or in a similar capacity.

- *Rule 205-3.* An SEC-registered adviser may only charge performance fees to “qualified clients”. The amended rule allows a newly registered adviser to maintain fee arrangements with current fund investors (whether or not they are qualified clients) and also permits a newly registered adviser to charge performance fees to clients that are not “qualified clients”, provided that such clients are clients of the adviser prior to February 10, 2005. A “qualified client” of an adviser means a client that meets *any* of the following criteria: (i) has a net worth in excess of \$1.5 million, (ii) has at least \$750,000 under management with such adviser, (iii) is a “knowledgeable employee” of such adviser, or (iv) is a “qualified purchaser” (*i.e.*, natural persons or family companies with a net worth of at least \$5 million, certain trusts, and investment companies with at least \$25 million in investments).

- *Rule 206(4)-2.* An SEC-registered adviser with custody over accounts for investors in a fund that is subject to an annual audit under generally accepted accounting principles must ensure delivery of the fund’s year-end audited financial statements to its investors within 120 days after the end of each fiscal year. The amended rule extends the deadline to deliver year-end audited financial statements from 120 to 180 days for advisers to “Fund of funds”. Such extension applies only to funds that invest at least 10% of assets in other funds.

- *Rule 222-2 and Rule 203A-3.* These rules require an adviser to count clients for various purposes. Rule 222-2 prohibits states from requiring any adviser with less than 6 clients to register. Rule 203A-3 provides that an “investment adviser representative,” (*i.e.*, a supervised person of the adviser), may be subject to state registration if the representative has more than 5 clients. Amendments to Rule 222-2 and Rule 203A-3 clarify that advisers do not need to apply the New Rule’s counting method for purposes of counting clients under these rules.

- *Form ADV.* Form ADV is the form advisers use to register with the SEC. Advisers required to register with the SEC for the first time under the New Rule must identify themselves as “Private Fund Advisers” on Form ADV. Advisers already registered with the SEC and covered by the New Rule must identify themselves as Private Fund Advisers in amendments to Form ADV filed with the SEC after March 8, 2005.

Levett Rockwood P.C. regularly counsels advisers about compliance with the Advisers Act. For more information about the New Rule and registration under the Advisers Act, contact either **Cheryl Johnson** or **Kate Grijns** of our office at (203) 222-0885.