SEC Requires Registration of Hedge Fund Advisers Under the Investment Advisers Act

On October 26, 2004, a divided Securities and Exchange Commission (SEC) voted to adopt changes to the rules under the Investment Advisers Act of 1940 (Advisers Act) that will require that advisers to and sponsors of many hedge funds register as investment advisers under the Advisers Act. The SEC released these new rules on December 2, 2004. The new rules are controversial both for the substantial change in regulatory policy implicit in their adoption as well as the divided vote of the SEC by which they were adopted.

The new rules will have a substantial effect on the way that hedge funds are structured and offered. The restrictions placed by the Advisers Act on incentive compensation – a standard method of compensation to hedge fund advisers – will require that hedge fund sponsors strengthen the suitability requirements for investors or change their form and method of compensation. Advisers will need to maintain substantial books and records, including performance records. In addition, fund advisers will be required to prepare and distribute certain disclosure documents to their clients at the outset of the advisory relationship.

Hedge funds have been under scrutiny by the SEC since early 2002, and a comprehensive Staff Report was released to the public in September 2003. During this time period, the Treasury Department considered adopting specific anti-money laundering rules for hedge funds and their sponsors. While no action has been taken by Treasury to finalize those proposed rules, the SEC has generally adopted the definition of "hedge fund" which was included in the Treasury Department proposal.

The new rules are intended to apply to traditional hedge funds as well as to many other private trading and investment funds, but not to most private equity, venture capital and real estate investment funds and pools. According to the SEC, these latter types of funds generally have purposes and investment objectives that are long-term in nature, and are appropriate to exempt from the scope of the new requirements. Thus, the new rules and requirements apply to advisers to funds that permit their investors to redeem their investments within two years of making the investment.

The new rules generally become effective on February 10, 2005, although certain changes to Form ADV (the form used to register an investment adviser with the SEC) will become effective on January 10, 2005. However, persons and firms who will be required to register as investment advisers by virtue of the new rules will have until February 1, 2006, to comply.

Background

The Advisers Act generally requires all investment advisers with at least $25 million under management to register with the SEC.[1] An adviser required to register must file an application (Form ADV) with the SEC and

[1] Investment advisers with less than $25 million under management are subject to the registration requirements of each state in which they conduct their advisory business.

maintain specified books and records, adopt pervasive policies including a code of ethics, appoint a chief compliance officer and provide certain reports and other disclosures to its advisory clients. Registered advisers are also subject to the substantive requirements of the Advisers Act, including prohibitions on certain types of fee arrangements.

Section 203(b)(3) of the Advisers Act provides an exemption from the registration requirements for a person who would otherwise be an "investment adviser" but who has had fewer than 15 clients during the prior 12 months, does not hold itself out generally to the public as an investment adviser and does not act as an investment adviser to a registered investment company or a business development company. In applying this exemption, Rule 203(b)(3)-1 historically has permitted investment advisers to count most entities – including hedge funds – as a single client, rather than counting the number of owners of or participants in the entity. Since the shareholders of a corporate fund, the members of a limited liability company fund and the partners of a partnership fund did not count as "clients," an adviser could advise or manage up to 14 hedge funds without being required to register as an investment adviser. By amending Rule 203(b)(3)-1 to require that fund sponsors and advisers "look through" their private funds to count each investor as a "client," the SEC effectively requires that most advisers to and sponsors of hedge funds register as investment advisers.

The New Rules and Amendments

Rule 203(b)(3)-1 has been amended so that a "private fund" is not considered to be a single client. Thus, in determining whether a person otherwise required to register as an investment adviser has 14 or fewer clients, that person must now count each owner of a private fund as a separate client.

Pursuant to amended Rule 203(b)(3)-1, a private fund will include most pooled investment or trading vehicles. Generally, any fund or pool which would be required to register as an "investment company" but for certain exemptions from such registration[2] and which is offered for sale based on the investment advisory skills, ability or expertise of the adviser or manager will be a private fund. Since virtually all hedge funds today rely on one of these two exemptions, the advisers to these funds will now have to count the investors in the funds, rather than the number of funds themselves, in determining whether they are exempt from the registration requirement.

However, not all pooled investment or trading funds are included within the definition of a "private fund." Most significantly, any entity which requires that all investors maintain their investments for an initial period of two years (a "two year lockup") is excluded from the definition of private fund.[3] This is intended by the SEC to exclude most real estate, private equity and other funds which do not, in the SEC's view, affect the type of securities trading for which Advisers Act registration is appropriate.

Under the new rule, if a registered investment company invests in a hedge fund, the sponsor or adviser to the hedge fund must count as clients each investor in the registered fund. Also, if an investor in a hedge fund is a "fund of funds," i.e., a fund the investors in which are themselves funds, the adviser must "look through" that entity and count the number of investors in the component funds to determine if it manages or advises more than 14 clients.

[2] Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, which provide exemptions for funds held by not more than 100 owners and for funds held only by "qualified purchasers" (which includes natural persons who have an investment portfolio of not less than $5 million and companies that direct investments of not less than $25 million), respectively.
[3] The two year lockup need not be absolute. For example, a fund may permit an investor to withdraw its contribute capital in the event of "extraordinary" circumstances and still utilize the two year lockup exemption.

The new rules will also require that offshore advisers consider their "onshore" (within the U.S.) business and thus may require that offshore advisers and managers register as investment advisers pursuant to the Advisers Act. An offshore hedge fund adviser must count the number of U.S. residents who are investors in each private fund which it advises or manages. If that number is greater than 14 and the investments by the U.S. residents exceed $25 million, it generally will be required to register with the SEC.

However, if a fund has its principal place of business outside of the U.S., makes a public offering outside of the U.S. and is regulated as a public investment company under the laws of a country other than the U.S., it is not considered a private fund. An adviser with offices in the U.S. may thus count such a fund as a single client. An offshore adviser may (as under prior rules) exclude such a fund entirely in counting its number of clients.

Transitional Rules and Exemptions

The SEC recognized that the regulatory requirements of the Advisers Act could create unintended adverse consequences for clients of many firms which will be required to register as Investment Advisers by virtue of the new rules. For example, most investment or trading funds and pools provide that the general partner or manager receives a portion of the operating profits of the pool or fund. However, Section 205(a)(1) of the Advisers Act, and Rule 205-3 under the Advisers Act, prohibit a registered investment adviser from receiving compensation based on a share of profits or gains (incentive-based compensation) unless the client is a "qualified client." Since a "qualified client" must meet minimum net worth or income requirements[4] that exceed those required of the typical investor in a hedge fund, applying this rule to existing hedge funds would seriously disrupt existing arrangements.

Accordingly, amendments to Rule 205-3 will permit an investment adviser to continue to charge and receive incentive-based compensation from any private fund which it advised or managed prior to its registration as an investment adviser, regardless of whether it is a qualified client. This exemption applies to the private fund rather than to its capital contribution or investment. Thus, once a fund investor has been "grandfathered," the adviser may continue to charge and receive incentive-based compensation on all invested funds of that fund investor.

In addition, a hedge fund adviser who is required to register by virtue of the new rules may continue to market the performance of its private funds even if the adviser does not maintain the documentation and information concerning the funds which Rule 204-2 under the Advisers Act otherwise requires as a condition to such marketing.

Finally, as noted above, hedge fund advisers and managers who are subject to these new rules will have until February 1, 2006, to register. The SEC intends this transition period to provide sufficient time for these advisers to complete the investment adviser registration process, for appropriate personnel to complete necessary examinations and for newly registered firms to adopt policies and procedures required under the Advisers Act and the rules thereunder,[5] including adopting a code of ethics, designating a chief compliance officer, creating the necessary books and records and complying with SEC requirements for custody of client funds and securities.

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[4] A "qualified client" includes persons with a minimum net worth of at least $1,500,000 or assets under management of not less than $750,000, a "qualified purchaser" as defined in Rule 144A and certain senior executives of the adviser.

[5] An overview of these requirements can be found in our October 4, 2004, Client Alert, "A Primer on New Rules for Investment Advisers."

For Further Information

If you have any questions regarding the new rules, including how they may affect your company, please contact one of the members of the Broker-Dealer/Financial Markets or Securities Practice Groups or the lawyer in the firm with whom you are regularly in contact.

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