

## SEC Approves New Rule Requiring the Registration of Investment Advisers to Hedge Funds

On October 26, 2004, the Securities and Exchange Commission (the "Commission") voted to adopt a new rule, Rule 203(b)(3)-2 under the Investment Advisers Act of 1940 (the "Advisers Act"), requiring certain investment advisers to hedge funds to register with the Commission under the Advisers Act. The final rule was released by the Commission on December 2, 2004. The new rule modifies the method of determining the number of clients under Section 203(b)(3) to eliminate the private investment adviser exemption on which most hedge fund advisers rely to avoid registration under the Advisers Act. The effective date of the new rule will be February 10, 2005. Advisers that will be required to register under the new rule must do so by February 1, 2006.

### I. Background

Under the current rule, private investment fund advisers that comply with the terms of Section 203(b)(3) can manage up to 14 private funds in any 12-month period without registering with the Commission or being subject to the examination and information reporting requirements of the Advisers Act. The Commission proposed the new rule on July 20, 2004, citing concerns arising from tremendous recent growth in the hedge fund industry and several notable enforcement actions. The goals of the new rule are to collect more and more reliable information about the hedge fund industry, enable the Commission to examine hedge fund advisers to identify and deter compliance problems, require hedge fund advisers to adopt compliance procedures, improve disclosures made to prospective and current hedge fund investors, and to prevent felons and other individuals with serious disciplinary records from managing hedge funds.

Despite strong opposition from Commissioners Glassman and Atkins, as well as Chairman Alan Greenspan of the Federal Reserve Board and Treasury Secretary John Snow, among others, on October 26, 2004 the Commission passed the new rule by a three votes to two margin. The opponents of the proposal argued that the measure was too drastic, that additional study was necessary, and that the new rule could have unintended adverse consequences.

### II. Modified Method of Counting Clients

The new rule modifies the method of determining the number of clients under Section 203(b)(3) of the Advisers Act. Section 203(b)(3) provides an exemption from registration for advisers who, among other things, advise fewer than 15 clients. In the past, a fund was counted as a single client. The new rule requires that an adviser look through each "private fund" it advises to the fund's investors for purposes of counting clients. A "private fund" is an investment company that (1) is excepted from registration under the Investment Company Act of 1940 by virtue of Section 3(c)(1) or 3(c)(7) thereunder, (2) permits owners to redeem their interests within two years of purchase; and (3) is offered based on the investment advisory skills, ability or expertise of the investment adviser. Thus, the only ways that a hedge fund adviser can remain exempt from registration under the new rule is if its clients together have fewer than 15 investors or if its fund clients impose a lock-up period on their investors of more than two years. A provision that provides a lock-up of more than two years for new investments made by new or existing clients will permit the advisor to continue to count the fund as a single client. The lock-up provision may also contain many of the provisions commonly found in lock-ups, including provisions which permit a client to be released from the lock-up in the event of the death or disability of a

client, death or disability of a key-man, a materially adverse tax or regulatory outcome (including the fund's assets becoming "plan assets" under ERISA), and where the continued holding of the private fund becomes impractical or illegal.

### III. Relief Afforded Under the Rule

The registration requirement under Section 203 only applies to investment advisers that manage at least \$25 million in assets. Thus, advisers of relatively small hedge funds are still exempt from federal registration.

The new rule also requires non-U.S. investment advisers to look through private funds for the purposes of determining if they have more than 14 U.S. clients. U.S. residency is determined at the time of the investment. Non-U.S. advisers who do have more than 14 clients will be required to register, to maintain certain books and records including personal trading records and remain subject to SEC staff examination, but are otherwise relieved of the requirements of the Advisers Act.

### IV. Additional Amendments

The staff also passed additional amendments intended to lessen the burden of the new rule on previously unregistered hedge fund advisers. These proposals are:

- Amending recordkeeping rules to permit a hedge fund adviser to continue to utilize performance history in its marketing materials, even in instances in which it had not retained the required supporting information for periods prior to registration. Advisers must retain all performance information they do possess;
- A "grandfather" provision for existing Section 3(c)(1) hedge fund investors that do not meet the Adviser Act's "qualified client" standard;<sup>1</sup>
- An extension under the custody rules to permit fund-of-funds to file their audited financial reports within 180 days of the fiscal year end, rather than 120 days, in recognition that such funds cannot prepare their reports until they receive audited information from the underlying funds in which they invest; and
- Modifying Form ADV to more clearly identify hedge fund advisers.

### V. Effective and Compliance Dates

The effective date of the new rule is February 10, 2005. Hedge fund advisers must be registered and in compliance with all policies and procedures of the Advisers Act, including custody rules, by February 1, 2006. The Commission has adopted this unusually long transition period to provide advisers with enough time to work through any technical issues they may encounter as they prepare for registration. Previously registered advisers must respond to the amendments to Form ADV in their regular annual updating amendment on or after March 8, 2005, but in any event by February 1, 2006.

### Contact Information

Ropes & Gray has prepared a brief summary of the major Advisers Act provisions applicable to hedge fund advisers which we would be happy to furnish to you. If you have any questions or would like to learn more about the proposed rule, please contact your regular legal advisor at Ropes & Gray.

<sup>1</sup> Rule 205-3 provides an exemption to the general rule under the Advisers Act that prohibits the payment of performance fees to registered investment advisers for advisers to persons meeting the "qualified client" standard. Absent this exemption, hedge fund advisers to Section 3(c)(1) funds that currently receive performance fees as compensation could not continue receiving such fees once registered unless all of the investors in its funds qualify as "qualified clients" within the meaning of Rule 205-3. Private investment funds exempt under Section 3(c)(7) are not subject to the restriction on performance fees.