SEC PROPOSES RULE REQUIRING HEDGE FUND ADVISERS TO REGISTER UNDER INVESTMENT ADVISERS ACT

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On July 14, 2004, the U.S. Securities and Exchange Commission (the "SEC") voted by a 3-2 majority to publish for comment proposed Rule 203(b)(3)-2 (the "Proposed Rule") under the U.S. Investment Advisers Act of 1940, as amended ("Advisers Act"). The Proposed Rule would have the practical effect of requiring most U.S. hedge fund advisers, as well as many non-U.S. hedge fund advisers to offshore funds with U.S. investors, to register as investment advisers with the SEC under the Advisers Act.

General

Under the "private adviser" exemption from registration under the Advisers Act, an investment adviser does not have to register with the SEC under the Advisers Act so long as it (i) has 14 or fewer clients in any twelve-month period, (ii) does not hold itself out to the public as an investment adviser and (iii) does not advise a fund registered under the U.S. Investment Company Act of 1940 (the "1940 Act"). Under a current SEC rule, a fund generally counts as one client irrespective of the number of investors in the fund so long as the fund receives investment advice based on its investment objectives and not the investment objectives of its investors. The Proposed Rule would modify this rule by requiring an adviser to a "private fund" to "look through" the fund and to count the number of investors in the fund (rather than only the fund itself) in determining whether the adviser is eligible for the private adviser exemption. Hence, an adviser to one or more private funds with more than 14 investors in the aggregate generally would be required to register with the SEC.[1]

Definition of "Private Fund"

A "private fund" under the Proposed Rule would be one that:

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1 The Proposed Rule would not alter the $25 million minimum assets under management that a U.S. adviser generally must have in order to be eligible to register with the SEC. Thus, a U.S. hedge fund adviser with more than 14 clients by virtue of the operation of the Proposed Rule but less than $25 million minimum assets under management would not be eligible to register with the SEC. The $25 million exclusion from SEC registration does not apply to non-U.S. advisers.

1. would be an investment company but for the exceptions in Sections 3(c)(1) or 3(c)(7) of the 1940 Act;[2]

2. permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and

3. is or has been offered based on the investment advisory skills, ability or expertise of the investment adviser.

As noted in (2) above, the Proposed Rule would not look through funds that do not permit their owners to redeem any portion of their ownership interests within two years of purchase (the "Redemption Test").[3] This limitation is intended to exclude from the operation of the Proposed Rule advisers of venture capital, private equity, real estate and other similar funds that require their investors to make a long-term commitment of capital. Recognizing that many such funds permit an investor to redeem under exceptional circumstances (e.g., if a violation of a law, regulation or governmental order applicable to the investor is likely to result without such redemption), the Proposed Rule states that a fund is not a "private fund" if it permits its owners to redeem their ownership interests within two years of the purchase of such interests only in the case of (i) events that the adviser finds after reasonable inquiry to be extraordinary and unforeseeable at the time the interest was issued and (ii) interests acquired with reinvested dividends.

A number of issues exist in the application of the Redemption Test that one hopes will be clarified or resolved during the comment process for the Proposed Rule. For example, some

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[2] Section 3(c)(1) of the 1940 Act generally excepts from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons (including after giving effect to certain "look through" rules) and which is not making and does not presently propose to make a public offering of its securities. Section 3(c)(7) of the 1940 Act excepts from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers" (as defined in Section 2(a)(51) of the 1940 Act) and that is not making, and does not propose to make, a public offering of its securities. A "qualified purchaser" as defined in Section 2(a)(51) of the 1940 Act, generally includes (i) any natural person who owns not less than $5 million in investments, (ii) a family-owned company that owns not less than $5 million in investments, (iii) certain trusts, and (iv) any other person that owns and invests on a discretionary basis not less than $25 million in investments.

[3] The SEC's approach to defining the scope of the Proposed Rule borrows from that taken recently by the U.S. Department of Treasury in defining the scope of its proposed rule requiring "unregistered investment companies" to adopt anti-money laundering programs. The Treasury's proposed rule does not require an anti-money laundering program to be maintained for a private investment fund that does not permit an owner to redeem his or her ownership interest in the fund within two years of the purchase of that interest.

hedge funds subject their investors to a basic lock-up of longer than two years but permit their investors annually to withdraw up to their profits, or amounts sufficient to pay taxes on their allocable share of the fund's income, or (in the case of certain charitable trusts) a stated percentage of their net asset value. In addition, some hedge funds generally subject their investors to a lock-up of longer than two years but permit redemptions or provide for the dissolution and winding up of the fund in the event of the departure of key personnel, a loss by the fund of greater than a specified percentage of its net asset value or the occurrence of certain adverse legal, tax or regulatory events with respect to the fund or the adviser. Other hedge funds subject most of their investors to a lock-up of longer than two years but enter into side agreements with certain investors to provide more favorable redemption rights. It is unclear how these arrangements would be treated under the Redemption Test. The SEC's formal release accompanying the Proposed Rule (the "Proposing Release") notes that offering redemption rights upon an investor's death or total disability or in circumstances that make it illegal or impractical for the investor to continue to own its interest in the private fund would not result in look-through under the Redemption Test. The Proposing Release also states that the Redemption Test would apply to each investment in the private fund (not only the investor's initial investment) and could be applied on a "first-in, first-out" basis.

An unintended side effect of the Redemption Test may be to cause some currently unregistered hedge fund advisers to further restrict the redemption rights they provide investors (i.e., by imposing a uniform lock-up of greater than two years) to avoid application of the Proposed Rule. This is particularly so since many of the leading hedge fund advisers currently enjoy a demand to invest in their funds that exceeds the capacity of their funds to accept new capital from investors.

Application to Non-U.S. Advisers

The Proposed Rule contains special provisions for advisers located outside the United States ("Non-U.S. Advisers") designed to limit the extraterritorial application of the Advisers Act to offshore advisers to offshore funds that have U.S. investors. In particular, a Non-U.S. Adviser to offshore private funds would be required to register only if, looking through to the investors in the offshore private funds, the Non-U.S. Adviser has more than 14 U.S. investors (excluding U.S. investors that moved to the U.S. subsequent to investing in the funds) in any 12-month period. In addition, an entity that has its principal office and place of business outside the United States, makes a public offering of its securities in a country outside the United States and is regulated as a public investment company under the laws of a country outside the United States (e.g., a UCITS fund) is excluded from the definition of a "private fund." As a result, advisers to offshore publicly offered mutual funds or closed-end funds would not be required to register with the SEC just because more than 14 of such funds' investors are U.S. investors. Finally, the Proposed Rule provides that an offshore fund subject to look-through under the Proposed Rule with a Non-U.S. Adviser would be treated as the Non-U.S Adviser's client (rather than having the fund's investors treated as clients) for all other purposes under the Advisers Act except the anti-fraud provisions of the Advisers Act. As a result, since the substantive provisions of the Advisers Act (e.g., relating to books and records, custody and compliance) do not apply to Non-U.S. Advisors in their dealings with non-U.S. clients, the substantive provisions of the Advisers Act would not apply to a Non-U.S. Adviser to an offshore private fund. Notwithstanding these special provisions, an unintended consequence of the Proposed Rule may be to preclude participation by U.S. investors in an offshore hedge fund if their participation results in the fund's Non-U.S. Adviser becoming subject to the burden of registration under the Advisers Act and SEC inspection.

Impact on Fund of Hedge Funds

The Proposed Rule would impact funds of hedge funds and underlying funds that accept investments from funds of hedge funds. In the first place, funds of hedge funds that are private funds would become subject to look-through, and consequently their advisers would generally be required to register.

In addition, an adviser to a private fund that has as an investor a fund of hedge funds that is a private fund would be required to count all of the investors in the top-tier fund as clients. Furthermore, an adviser to a private fund that has as an investor a registered investment company would be required to count all of the investors in the registered investment company as clients. The Proposing Release states that an adviser to the underlying private fund would not be required to receive information as to the precise number or identity of the top-tier investors where the adviser to the top-tier fund confirms to the underlying adviser that the top-tier fund has more than 14 investors. These further look-through provisions applicable to funds of hedge funds may make them less attractive as investors for underlying private funds.

Related Rule Changes

To mitigate some of the potentially adverse consequences of the Proposed Rule for hedge fund advisers, the SEC has also proposed a number of accompanying rule changes relating to the recordkeeping, performance fee, and custody rules applicable to registered advisers. First, an adviser that is required to register because of the Proposed Rule would be excused from the requirements of the recordkeeping rule under the Advisers Act relating to the adviser's performance "track record" for periods prior to the effective date of the Proposed Rule to the extent that the adviser's existing records are incomplete or otherwise do not meet the requirements of the recordkeeping rule. Second, the rule under the Advisers Act that permits a registered adviser to charge otherwise prohibited performance fees to "qualified clients" (generally, clients with a net worth of at least $1.5 million or at least $750,000 of assets under management with the adviser) would be amended to allow an adviser that is required to register because of the Proposed Rule to charge a performance fee to existing investors in the adviser's funds who are not "qualified clients," and such investors would be permitted to retain their investments in those funds and to make further investments in those funds. Finally, the SEC proposes to amend the custody rule to permit a registered adviser to a pooled investment vehicle, including a hedge fund, to satisfy the adviser's obligation to deliver account information to the investment vehicle's investors by distributing the investment vehicle's audited financial statements to its investors within 180 days of the investment vehicle's fiscal year end (rather than 120 days as is currently required).

Prospects for Adoption

The comment period for the Proposed Rule extends to September 15, 2004. Although a narrow majority of the SEC commissioners, as well as the SEC staff, seem firmly determined to adopt some version of the Proposed Rule later this year, it is unclear whether the Proposed Rule in a more or less comparable form will be adopted. Two SEC commissioners issued strong dissents to the SEC's decision in favor the Proposed Rule. In addition, Alan Greenspan, the Chairman of the Federal Reserve Board, as well as leading Bush Administration officials and several prominent members of Congress have expressed opposition to the Proposed Rule. Moreover, the hedge fund industry has announced it will undertake a vigorous lobbying effort to prevent adoption of the Proposed Rule.

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