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Investment Services Bulletin

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Hedge Fund Update

On October 26, 2004, the Securities and Exchange Commission (the "Commission") adopted a new rule and rule amendments (the "New Rules") that will require most hedge fund advisers to register as investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"). The New Rules may have a significant impact on hedge fund advisers, depending on the size, structure and operations of the adviser and its funds. Advisers who must register as a result of the New Rules must register under, and be in full compliance with, the Advisers Act no later than February 1, 2006.

REGISTRATION OF CERTAIN HEDGE FUND ADVISERS

Impact of New Rules

The New Rules will require investment advisers to private funds that currently rely on the "private adviser" exemption[1] to take the following steps on or before February 1, 2006:

- Assess whether or not the New Rules require you to register with the Commission as an investment adviser. As a general rule, many advisers to hedge funds will be required to register under the New Rules. Advisers to venture capital and private equity funds likely will not need to register.
- Designate a Chief Compliance Officer.
- Develop *written* compliance policies and procedures that comply with the Advisers Act.
- Implement a records program that complies with the Advisers Act.
- Review fund and adviser operations for compliance with the Advisers Act. Particular areas of emphasis include performance fees, custody issues and marketing practices.
- Register no later than February 1, 2006. If you choose to register early, you must comply with all provisions of the Advisers Act as of the date of your effectiveness.

Assess Registration Requirements

The New Rules require investment advisers to "private funds" to count all investors in the fund, rather than only the fund itself, for the purpose of determining the availability of the private adviser exemption.[2] The New Rules define a "private fund" as a fund that[3]:

1) would be an investment company but for the exceptions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940;[4]
2) permits investors 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.

This definition was intended to exclude private equity funds and venture capital funds, which require long-term capital commitments, from the definition of a private fund. The definition also was intended to exclude structured finance vehicles from the definition of a private fund. Nevertheless, we urge all advisers of private pooled vehicles to review their particular circumstances to ensure that they are not inadvertently covered by the New Rules.

An adviser to a private fund must count all investors in the fund, rather than only the fund, as clients for the purpose of determining the availability of the private adviser exemption. The fund itself does not count, and certain insiders do not count, as clients for this purpose. Because most hedge funds have more than fourteen investors, most investment advisers to hedge funds will be required to register as a result of the New Rules.

The New Rules specifically address the treatment of non-U.S. advisers. If you are a non-U.S. adviser to a private fund and you accept subscriptions from U.S. investors, you should review the application of the New Rules to your circumstances.

If an adviser has fifteen or more clients and assets under management in excess of $30 million, it must register with the Commission. If an adviser has assets under management between $25 and $30 million, it may, but is not required to, register with the Commission. If an adviser has less than $25 million in assets under management, state law will apply. While the "look through" provisions of the New Rules do not expressly extend to states, it is possible that states also will seek to regulate hedge fund advisers.

To register with the Commission, an investment adviser must submit Part I of Form ADV electronically through the IARD system and must complete and maintain Part II of Form ADV (or a comparable brochure). Part II generally includes a detailed description of services and products, fees, biographies of key personnel, investment management approach, brokerage and trading practices, and conflicts of interest.

You will need to have many of your compliance policies and procedures in place in order to complete your registration. You should also allow 30 days for the Commission to process your registration. We recommend that you commence the registration process several months in advance of the deadline.

Develop Compliance Program

The Advisers Act also requires registered advisers to designate a Chief Compliance Officer (CCO). A CCO must be a supervised person of the firm and is responsible for administering the firm's compliance policies and procedures.[5] The staff of the Commission has indicated that such person should be a person of stature within the firm and should have the requisite authority to carry out his function.

The Advisers Act requires registered advisers to (i) adopt and implement written policies and procedures reasonably designed to prevent violation by the firm and its supervised persons of the provisions of the Advisers Act and rules thereunder, and (ii) review no less frequently than annually the adequacy of such policies and procedures and the effectiveness of their implementation. Advisers to hedge funds should focus in particular on conflicts raised by the typical hedge fund structure, including significant personal investment by insiders, the use of performance fees, and side-by-side management of long only and long/short portfolios.

In addition to this general requirement, the Advisers Act specifically requires registered advisers to adopt (i) written policies and procedures to prevent insider trading, (ii) a Code of Ethics governing personal trading and other matters, and (iii) written policies and procedures governing proxy voting. The staff of the Commission also noted several specific topics that should be covered by a firm's written compliance policies when it adopted the new CCO and compliance procedure requirements.[6]

In addition, other regulations (*e.g.*, Regulation S-P) may apply to a registered investment adviser that did not apply to an exempt investment adviser.

Compliance with this portion of the Advisers Act rules may require significant enhancements to personnel, policies and procedures, and systems. Some firms will need to consider hiring an external person to fulfill the Chief Compliance Officer role.

Implement Records Program

The Advisers Act imposes extensive records requirements on registered investment advisers. The New Rules provide that all records of a private fund for which a registered investment adviser or its affiliate serves as general partner, managing member or in a

similar capacity shall be considered records of the adviser. This means such records must be maintained in accordance with the Advisers Act and, more significantly, are available to the Commission staff upon inspection.

The New Rules also address the use of performance information. The New Rules allow a newly registered private fund adviser to continue to use performance information for private funds and separate accounts even though the adviser's records prior to its registration likely did not meet the Advisers Act requirements. The newly registered adviser must maintain compliant records from the date of the effectiveness of its registration. The adviser must maintain whatever supporting records it has for the period prior to its registration.

Review Fund and Adviser Operations

The New Rules will require newly registered advisers to review the terms and structure of their hedge fund products and, in some cases, to change the fund structure or documentation. In addition, newly registered advisers will need to review the operations of the adviser for compliance with substantive provisions of the Advisers Act. Three areas of focus include performance fees, custody rules, and marketing practices.

The Advisers Act generally precludes the use of performance fees (*i.e.*, fees based on capital gains or appreciation), except for "qualified clients." The typical hedge fund performance fee structure is precluded by this provision. Accordingly, newly registered advisers must limit their use of performance fees to "qualified clients" on a going-forward basis.[7] A 3(c)(7) fund is deemed to be a qualified client. Hedge fund advisers to 3(c)(1) funds will need to implement grandfather provisions for existing investors and will need to revise their subscription materials to take into account the new qualified client provisions for each individual investor.

For many hedge funds, the investment adviser or an affiliate also serves as general partner or managing member. The Commission takes the position that the adviser is deemed to have custody of such assets. In order to meet Advisers Act rules governing custody, the fund must deliver audited financial statements to investors within 120 days of the fund's fiscal year end (180 days for hedge fund-of-funds).

The Advisers Act includes detailed records requirements to support performance presentations and imposes several substantive requirements on the content of marketing materials. Additionally, the Advisers Act requires a registered investment adviser to enter into a written agreement containing certain provisions with all third-party solicitors and to ensure that the solicitor discloses the arrangement to potential clients. Accordingly, newly registered advisers should evaluate whether any solicitation or referral arrangements must comply with these provisions of the Advisers Act.

Effective and Compliance Dates

The New Rules were effective February 10, 2005. Private fund advisers may elect to begin complying with the New Rules as of their effective date, but must comply no later than February 1, 2006. An adviser must comply with all provisions of the Advisers Act upon the effectiveness of its registration.

[1] Currently, many investment advisers to hedge funds rely on the "private client" exemption, which exempts an investment adviser from registration with the Securities and Exchange Commission if it had fewer than fifteen clients during the preceding twelve months, and it does not hold itself out to the public as an investment adviser or act as an investment adviser to a registered investment company. Prior to the New Rules, a hedge fund counted as a single client for this purpose. Advisers Act, Section 203(b) and former Rule 203(b)(3)-1.

[2] Rule 203(b)(3)-1.

[3] Rule 203(b)(3)-2.

[4] Section 3(c)(1) of the Investment Company Act excludes from the definition of "investment company" those funds with fewer than 100 shareholders, and Section 3(c)(7) of the Investment Company Act excludes from the definition of "investment company" those funds that permit only investors that are "qualified purchasers." Most hedge funds, private equity funds and venture capital funds rely on these provisions.

[5] The requirement to designate a Chief Compliance Officer was effective February 5, 2004, with an October 5, 2004 compliance date. The requirement generated much debate and, in particular, raised concerns regarding the potential liability of such person. A complete discussion of these issues is beyond the scope of this article.

[6] Investment Advisers Act Release No. 2204 (December 17, 2003). These areas include, without limitation, valuation and client reporting, trade allocations, best execution, affiliated transactions, confidentiality of customer information, recordkeeping and business continuity planning.

[7] In order to prevent disruption in the operation of hedge funds, the Commission grandfathered in existing investors. This exemption applies to additional capital contributions of such investors, but not to a new account opened by such an investor or an investment in a new fund by such investor.

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If you have any questions regarding material in this issue of the *Investment Services Bulletin,* please contact the authors or your regular Vedder Price contacts.

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