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THE FOLEY ADVISER

February 2005

SEC ADOPTS RULES REQUIRING REGISTRATION OF HEDGE FUND ADVISERS

New Counting Rules for Advisers to Private Funds

The Securities and Exchange Commission recently adopted a series of rules that will require most hedge fund advisers not currently registered with the Securities and Exchange Commission ("SEC") to register as investment advisers under the Investment Advisers Act of 1940, as amended (the "Act"). Under prior law, advisers could have up to 14 clients without registering, provided that they did not hold themselves out to the public as an adviser. The rules under the Act treated a fund as one client for purposes of this exemption and did not require the adviser to count the fund's investors as separate clients. Under the new rules, the SEC will now require advisers to "private funds" to look through such funds and count the underlying investors as clients, along with any other clients the adviser may have. The fund itself will not count as a client, nor does the adviser have to count itself as a client. The adviser may also exclude from the count certain knowledgeable employees of the adviser. An adviser with 15 or more clients under this revised rule will now have to register, except as set forth below. An adviser must look through any private funds (funds of funds) which have invested in its fund for purposes of counting the number of clients.

A "private fund" is defined to mean a fund, which (i) would be a regulated investment company (mutual fund) but for its reliance on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (which is the case for all hedge funds), (ii) permits redemption of interests or shares within two years of purchase (this provision applies to each purchase of an interest or share or capital contribution) and (iii) offers its interests based on the investment adviser's skills or expertise. The exclusion for funds which do not permit redemptions within two years of purchase is intended to carve out venture capital and private equity funds from the look-through requirement so that managers of such funds will still be able to treat each fund under management as one client. The SEC made a policy determination that venture and private equity fund managers should not be required to register unless they manage 15 or more funds. The new rules do allow a fund to permit redemptions within the two-year period under "extraordinary circumstances" without being deemed to be a private fund. An example of an extraordinary circumstance is the death of the investor or of a key person at the adviser. Also, investments made prior to February 1, 2006 are not subject to the two-year redemption test when determining if a fund qualifies as a private fund.

The SEC has not changed its requirement that an adviser must be managing at least $25 million in assets before it is eligible to register with the SEC, and must be managing at least $30 million before it is required to register. As a result, even with the change in the rules for counting clients, advisers with less than $30 million under management will not be required to register with the SEC, subject to certain exceptions for advisers to mutual funds (who must register in all cases) and offshore advisers (see below). An adviser is not required to count proprietary assets when determining if it is managing $30 million nor is it required to count assets contributed by certain knowledgeable employees.

What It Means To Be Registered

Advisers seeking registration must file a Form ADV Part I with the SEC. Part I of the ADV is filed electronically. Advisers must also prepare Form ADV Part II, which is a client disclosure document. Once registered, an adviser must comply with all aspects of the Act. Among other things, the Act requires an Adviser to do the following:

- Adopt written policies and procedures designed to ensure compliance with the securities laws, including the Act, and appoint a chief compliance officer
- Adopt a code of ethics, including requirements for reporting personal trades
- Adopt a policy against insider trading
- Adopt a proxy voting policy
- Adopt a privacy policy
- Comply with the SEC's recordkeeping requirements
- Comply with SEC rules on which clients are eligible to be charged a performance fee
- Comply with the SEC rules and staff positions on advertising
- Comply with the SEC custody rule
- Submit to periodic examinations by the SEC staff

Offshore Advisers

Offshore advisers (advisers located outside the United States) are also subject to the look-through rule and the registration requirements. However, the $25 million/$30 million under management rules do not apply to offshore advisers, which must register if they have 15 or more U.S. clients regardless of the assets under management. Under the new rules, offshore advisers must look through an offshore private fund with any U.S. investors (and any U.S. private fund) and count such U.S. investors as separate clients. The new rules do provide significant regulatory relief from the specific requirements under the Act for a registered offshore adviser whose only U.S. clients are through an offshore private fund. The application of the new rules to offshore advisers is complex, and offshore advisers should consult with counsel.

Grandfathering Provisions

The new rules do provide some special relief for advisers required to register under the new rules. The SEC will continue to allow such advisers to advertise their past performance even if the adviser does not have the records otherwise required by the SEC in connection with performance advertising. As of February 10, 2005, however, such advisers must begin to keep the records required by the SEC in connection with performance advertising even if the adviser has not yet registered. The SEC will also permit advisers to continue to charge a performance fee to existing investors in their existing funds who would not otherwise be eligible to be charged a performance fee under SEC rules. Starting on February 10, 2005, however, any new investor in the fund must be performance fee eligible under SEC rules even if the adviser has not yet registered.

Other Provisions

The new rules also made certain other changes. The new rules allow a fund of funds (as defined under the new rules) to distribute audited financial statements to investors within 180 days of the end of the fund's fiscal year and still be in compliance with the requirements of the SEC's custody rule. Under the prior rules, a fund of funds only had 120 days to distribute its audited financials. The new rules also amend Form ADV, effective March 8, 2005, so that advisers to hedge funds filing a Form ADV (or an amendment to Form ADV) after March 8, 2005 will be required to identify themselves as such.

The SEC has made clear that the new counting rules apply only in the context of determining whether an adviser must register with the SEC, and do not change advisers' methods of counting clients for other purposes such as the national "de minimis" standard for state adviser registration or the definition of "investment adviser representative."

Compliance Dates

The compliance date for the registration requirement is February 1, 2006. Advisers required to register under the new rules must have completed their registration (not merely applied) and be in compliance with all aspects of the Act by that date. Advisers should note that the registration and compliance process can take ten weeks or more. Consequently, advisers should begin the registration process no later than October 1 of this year.

Investment advisers with questions about any of these matters should contact Peter Rosenblum or Jeffrey Collins in Foley Hoag's Investment Management Group at (617) 832-1000.