



# GlobalNote

## **Final Rules to Require Certain Hedge Fund Managers to Register with the SEC<sup>1</sup>**

**To: Clients and Friends of Tannenbaum Helpern Syracuse & Hirschtritt LLP**

**Date: December, 2004**

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On December 2, 2004, the Securities and Exchange Commission (the "SEC") released final rules that will require certain hedge fund managers to register as investment advisers with the SEC under the Investment Advisers Act of 1940, as amended (the "Advisers Act").<sup>2</sup> In addition, Release No. IA-2333 contains transitional amendments to the qualified client rule (relating to client eligibility in charging performance fees or performance allocations)<sup>3</sup> and the rules regulating performance advertisement<sup>4</sup> to accommodate non-registered hedge fund managers that must now register with the SEC. The custody rule was also amended to accommodate operators of fund-of-funds.<sup>5</sup> Significantly, the SEC staff clarified the extent compliance with the Advisers Act applies to non-U.S. based investment advisers that register with the SEC.

This Memorandum addresses the following topics: (i) who must now register as a result of the adoption of Rule 203(b)(3)-2 under the Advisers Act and the amendments to existing rule; (ii) the consequences of registering as an investment adviser (completing Form ADV and compliance with *inter alia* the written compliance program, the Code of Ethics, the solicitation rule, valuation, the qualified client rule, past performance, and

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<sup>1</sup> This Memorandum provides general information on the subject matter described, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects discussed herein. For further information see the firm's website: [www.tannenbaumlaw.com](http://www.tannenbaumlaw.com)

<sup>2</sup> See Release No. IA-2333 (December 2, 2004) ("Release No. IA-2333"). See also Securities and Exchange Commission; Registration Under the Advisers Act of Certain Hedge Fund Advisers; proposed rule. 69 Fed. Reg. 45172 (July 28, 2004).

<sup>3</sup> See amended Rule 205-3(c)(2) under the Advisers Act

<sup>4</sup> See amended Rule 204-2(e)(3)(ii) under the Advisers Act.

<sup>5</sup> See amended Rule 206(4)-2(b)(3) and (c)(4) under the Advisers Act.

books and records); (iii) the application of Rule 203(b)(3)-2 with respect to non-U.S. based hedge fund managers; and (iv) the amended custody rule.

## **I. Compliance Dates**

Non-registered hedge fund managers that are required to register with the SEC under new Rule 203(b)(3)-2 under the Advisers Act must do so by February 1, 2006.<sup>6</sup> By February 1, 2006, fund managers required to register must have filed Part I of Form ADV, adopted the various compliance policies and procedures required under the Advisers Act, and appointed a chief compliance officer.<sup>7</sup>

An unregistered hedge fund manager of a fund that relies on Section 3(c)(1) of the Investment Company Act of 1940, as amended (the “Company Act”) that finds itself having to register with the SEC will be limited to accepting investors which satisfy the criteria of a “qualified client” as described under Rule 205-3(d)(1) after February 10, 2005 if such hedge fund manager is charging a performance fee or a performance allocation.

Hedge fund managers that are *currently registered* as investment advisers must respond to Part 1A, Item 7 and Section 7.B. of Schedule D of the amended Form ADV Part I after March 8, 2005 and must in any event respond to Item 7.B. by February 1, 2006.<sup>8</sup>

## **II. Who Must Register**

Until the adoption of Rule 203(b)(3)-2 under the Advisers Act, unregistered hedge fund managers have been able to rely on the exemption from investment adviser registration pursuant to Section 203(b)(3) of the Advisers Act and Rule 203(b)(3)-1 under the Adviser Act. The prevailing rule has been that the fund itself and not the underlying beneficial owners of such fund is the client because under Rule 203(b)(3)-1(a)(2)(i) an entity such as a limited partnership, limited liability company or a corporation is counted as one client for the purposes of determining the number of advisory clients an adviser has. Accordingly, as long as the hedge fund manager provides investment advisory services to fourteen or less funds then such a fund manager has been exempt from registration because it has fourteen or less clients under the safe harbor of Section 203(b)(3) of the Advisers Act.<sup>9</sup>

Section 203(b)(3) of the Advisers Act and Rule 203(b)(3)-1 under the Advisers Act no longer applies to hedge fund managers for the purposes of determining whether a hedge

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<sup>6</sup> Release No. IA-2333, at 82.

<sup>7</sup> Release No. IA-2333, at 82-83.

<sup>8</sup> Release No. IA-2333, at 84.

<sup>9</sup> An investment adviser is not required to register with the SEC if it: (i) has fewer than fifteen advisory clients in any twelve month period; (ii) does not hold itself out generally to the public as an investment adviser; and (iii) does not advise a registered investment company or a business development company. See Section 203(b)(3) of the Advisers Act.

fund manager provides investment advisory services to fourteen or less clients.<sup>10</sup> Rule 203(b)(3)-2 is now the controlling rule that obligates fund managers to “look through” the “private fund” that they operate and to count the number of investors within the fund to determine whether the fund manager has fifteen or more clients.

The test to determine whether a *U.S.-based hedge fund manager* must register with the SEC is a three-tier process: (i) does the hedge fund manager operate a “private fund”; (ii) does the hedge fund manager have fifteen or more clients (i.e., investors); and (iii) do the amount of assets under management exceed \$25 million/\$30 million. Essentially, if (i) the pooled investment vehicle falls within the definition of “private fund,” (ii) there are fifteen or more clients in the aggregate and (iii) the fund manager manages U.S.\$30 million or more of assets under management, then the hedge fund manager will be required to register with the SEC pursuant to the Advisers Act.

### **A. Does the Hedge Fund Manager Operate a “Private Fund”**

Since there is no statutory definition of the term “hedge fund,” the SEC staff adopted the new term “private fund” as a means to determine whether an investment adviser of a pooled investment vehicle would have to register as an investment adviser under Rule 203(b)(3)-2 under the Advisers Act.

A “private fund” is defined to mean the following:

A company:

- (i) that would be an investment company under Section 3(a) of the Investment Company Act but for the exception provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of such Act;
- (ii) that permits owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and
- (iii) interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.<sup>11</sup>

A pooled investment vehicle that does not satisfy any one of the three elements is not a “private fund.” As such, an unregistered investment adviser that operates such a fund may continue to rely on the exemption from investment adviser registration under Section 203(b)(3) and Rule 203(b)(3)-1 under the Advisers Act. Accordingly, a pooled investment vehicle that is not a “private fund” remains treated as a single client.<sup>12</sup>

#### 1. Section 3(c)(1) and 3(c)(7) of the Company Act

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<sup>10</sup> The safe harbor from registration as an investment adviser is not available with respect to private funds. See Preliminary Note to Section 275.203(b)(3)-1 of the Advisers Act. The SEC explicitly stated: “We are amending rule 203(b)(3)-1 to clarify that investment advisers may not count hedge funds as single clients under the safe harbor.” Release No. IA-2333, at 75.

<sup>11</sup> See Section 203(b)(3)-1(d) of the Advisers Act.

<sup>12</sup> See Section 203(b)(3)-1(a)(2)(i) of the Advisers Act.

A pooled investment vehicle is not a “private fund” unless it is a company that would be subject to regulation under the Company Act but for the exception from the definition of “investment company” provided in either Section 3(c)(1) or 3(c)(7) of the Company Act.<sup>13</sup>

A pooled investment vehicle that is relying on any other exemption from the definition of “investment company” is excluded from the definition of “private fund.”

## 2. Redemption within Two Years

A pooled investment vehicle is a “private fund” only if it permits investors to redeem their interests in the fund within two years of purchase.<sup>14</sup> The two-year element applies to each interest purchased or amount of capital contributed to the pooled investment vehicle.<sup>15</sup>

Note that a hedge fund manager that imposes a lock-up period of more than two years but enters into side letters with certain investors that permit redemptions prior to the expiration of the prescribed lock-up, i.e. “most favored nation status,” cannot use side letters as a means to bypass the two-year redemption test.<sup>16</sup> According to the SEC staff, a pooled investment vehicle that uses side letters to provide some, but not all, investors the opportunity to redeem shares within two years would meet the definition of a “private fund.”<sup>17</sup>

The SEC adopted the two-year lock-up element because it believes that other pooled investment vehicles such as private equity funds, venture capital funds, and similar funds require investors to make long-term capital commitments. According to the SEC staff, the SEC has not encountered significant enforcement problems with respect to private equity fund and venture capital funds, and therefore the SEC believes that advisers to such funds should not be the focus of its examination staff resources.<sup>18</sup>

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<sup>13</sup> Release No. IA-2333, at 69, note 226. Section 3(c)(1) excepts from the definition of investment company an issuer that is beneficially owned by not more than 100 persons that are accredited investors as defined in Rule 506 of Regulation D and that is privately placing its securities. Section 3(c)(7) excepts from the definition of investment company an issuer that is beneficially owned exclusively by qualified purchasers as defined in Section 2(a)(51)(A) of the Company Act and that is privately placing its securities.

<sup>14</sup> The SEC staff found that “hedge funds generally offer semi-annual, quarterly, or monthly liquidity terms to their investors.” Release No. IA-2333, at 72, note 233. Also, according to the SEC staff, “periodic redemption rights offered by hedge funds provide the hedge fund investors with a level of liquidity that allows the investor to withdraw a portion of his or her assets, controlled by the adviser, or to terminate the relationship with the hedge fund adviser and choose a new adviser.” The SEC staff believes that this redeemability feature of the definition of “private fund” will promote the purposes of the Advisers Act by applying the rule to those relationships that the Advisers Act was designed to address. Release No. IA-2333, at 73, note 237.

<sup>15</sup> The SEC is permitting funds to use a “first in, first out” basis for determining the age of purchases and capital contributions. Release No. IA-2333, at 71, note 231.

<sup>16</sup> Release No. IA-2333, at 72, note 233.

<sup>17</sup> Release No. IA-2333, at 72, note 233.

<sup>18</sup> Release No. IA-2333, at 72-73.

The final rule also permits a pooled investment vehicle to offer redemption rights under extraordinary circumstances without being considered a “private fund” in recognition that private equity funds and venture capital funds may offer redemption rights under extraordinary circumstances whereby an investor may redeem within a two-year period following its capital contribution to the fund.<sup>19</sup>

Furthermore, the SEC staff has taken the position that offering redemption rights that permit an investor to redeem part of all of its investment under the following circumstances will not cause the pooled investment vehicle to be treated as a “private fund”: holding the investment in the pooled investment vehicle becomes impractical or illegal, a key man provision is triggered (death or disability of the portfolio manager), there is a merger or reorganization of the investment vehicle, maintaining the investment would result in a materially adverse tax or regulatory outcome, or to keep the investment vehicle’s assets from being considered “plan assets” under ERISA.<sup>20</sup>

### 3. Advisory Skills, Ability, or Expertise

A pooled investment vehicle is a “private fund” only if interests are offered based on the investment advisory skills, ability or expertise of the investment adviser.<sup>21</sup> The third element applies to funds that are marketed based on the skills, ability and expertise of the adviser to the funds. According to the SEC staff, a hedge fund adviser’s history, experience, past performance, strategies, and disciplinary record are factors that are likely important to investors who rely on the adviser for their investment’s success in deciding whether to invest in a particular hedge fund.<sup>22</sup> According to the SEC staff, investors not only expect to receive but are solicited explicitly on the basis of the investment management ability of the hedge fund manager.<sup>23</sup> As such, the SEC staff adopted this element to confirm the direct link between the fund manager’s management services and the investors’ decision to invest in such adviser’s fund.<sup>24</sup>

## **B. Counting Clients When a U.S.-Based Hedge Fund Manager**

If the pooled investment vehicle meets the definition of “private fund,” then the next step is to “look through” the private fund to determine the number of clients. In general, a hedge fund manager “must count as clients the shareholders, limited partners, members or beneficiaries” of a “private fund.”<sup>25</sup>

A U.S.-based hedge fund manager counts both U.S. investors and non-U.S. investors towards the 14-client threshold.<sup>26</sup>

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<sup>19</sup> Rule 203(b)(3)-1(d)(2)(i) under the Advisers Act; Release No. IA-2333, at 73.

<sup>20</sup> Release No. IA-2333, at 73-74, note 240.

<sup>21</sup> Release No. IA-2333, at 74.

<sup>22</sup> Release No. IA-2333, at 74.

<sup>23</sup> Release No. IA-2333, at 53.

<sup>24</sup> Release No. IA-2333, at 53.

<sup>25</sup> Rule 203(b)(3)-2(a) under the Advisers Act.

<sup>26</sup> Rule 203(b)(3)-1(b)(5) under the Advisers Act.

Note that a hedge fund manager is to count investors in the aggregate when determining if the fund manager has fifteen or more clients. For example, if an adviser operates two “private funds,” each of which has eight investors, then the adviser has sixteen clients in the aggregate and therefore must register with the SEC.<sup>27</sup>

Furthermore, if the fund manager advises managed accounts as well, each managed account counts towards the 14-client threshold.<sup>28</sup>

### 1. When to “Look Through” the Investor Itself in a Private Fund

A U.S.-based hedge fund manager looks through the following investors:

- A pooled investment vehicle that satisfies the definition of “private fund”<sup>29</sup>
- A “private fund” that is a fund-of-funds<sup>30</sup>
- A registered investment company that is a fund-of-funds<sup>31</sup>
- Non-U.S. domiciled pooled investment vehicles that are offered in the U.S. in reliance on the Touche Remnant & Co. SEC staff no-action letter or the Goodwin, Proctor, & Hoar SEC staff no-action letter.<sup>32</sup>

Note that a hedge fund manager is to look through an investor that is a master fund if the master fund has a feeder fund that (i) satisfies the definition of “private fund” and (ii) has U.S. investors.<sup>33</sup> In such a situation, the hedge fund manager is to count the total number of U.S. investors in the master-feeder complex.

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<sup>27</sup> Release No. IA-2333, at 58, note 186.

<sup>28</sup> “[A]n adviser that advises individual clients directly must count those clients together with the investors in any private fund it advises in determining its total number of clients for purposes of section 203(b)(3).” Release No. IA-2333, at 58.

<sup>29</sup> Rule 203(b)(3)-2(a) under the Advisers Act. A hedge fund manager cannot rely on Rule 203(b)(3)-1(a)(2) with respect to any entity that is a “private fund.” See Rule 203(b)(3)-1(b)(5) under the Advisers Act. However, an entity *other than* a “private fund” that is a corporation, general partnership, limited partnership, limited liability or trust (other than a family trust) is to be treated as a single client. See Rule 203(b)(3)-1(a)(2) under the Advisers Act.

<sup>30</sup> Release No. IA-2333, at 61. However, an adviser to the underlying portfolio fund is not required to receive information as to the identities of investors in the fund-of-funds and does not have to receive the precise number of investors in the fund-of-funds. Release No. IA-2333, at 61, note 196. An adviser to a portfolio fund in which a fund-of-funds is investing in must look through the top tier fund, i.e., the fund-of-funds, and count that fund-of-funds’ investors as clients for purposes of determining whether the adviser to the portfolio fund must register with the SEC. Once the adviser to the portfolio fund has looked through the fund-of-funds, the underlying adviser may then apply the provisions of Rule 203(b)(3)-1(a)(1) with respect to the fund-of-funds’ investors. Release No. IA-2333, at 76, note 250.

<sup>31</sup> Rule 203(b)(3)-2(b) under the Advisers Act; Rule Release No. IA-2333, at 61.

<sup>32</sup> Release No. IA-2333, at 69-70, notes 226-227. Touche Remnant & Co., SEC Staff No-Action Letter (Aug. 27, 1984) (an offshore fund may be privately offered to U.S. investors that are accredited investors as defined in Rule 506 under Regulation D of the Securities Act of 1933, as amended, pursuant to Section 3(c)(1) of the Company Act). Goodwin, Proctor & Hoar, SEC Staff No-Action Letter (Feb. 28, 1997) (an offshore fund may be privately offered to U.S. investors that are qualified purchasers as defined in Section 2(a)(51)(A) of the Company Act pursuant to Section 3(c)(7) of the Company Act).

<sup>33</sup> Release No. IA-2333, at 70, note 227.

Operators of fund-of-funds that are either “private funds” or registered investment companies should expect to receive a notice from the unregistered advisers of their underlying portfolio fund asking for the number of investors in their fund-of-funds during the next year. As such, operators of these fund-of-funds will have to undertake the process of looking through their own fund and monitoring the number of their own investors so that they can represent to the underlying portfolio funds that they invest the number of investors.

## 2. When Not to “Look Through” the Investor in a Private Fund

A hedge fund manager may continue to rely on the safe harbor of Rule 203(b)(3)-1 under the Advisers Act for purposes of counting clients with respect to investors that do not fall within the definition of “private fund.”<sup>34</sup> As such, the following are to be treated as a “single client” when counting clients for the purposes of Rule 203(b)(3)-2 under the Advisers Act:

- A natural person, and:
  - The natural person’s minor children;
  - The natural person’s relative, spouse and relative of the spouse who share the same principal residence;
  - Any accounts of which the only primary beneficiaries are the foregoing persons described above; and
  - Any trusts of which the only primary beneficiaries are the foregoing persons described above.<sup>35</sup>
- An entity investor other than a “private fund” that is a corporation, general partnership, limited partnership, limited liability company, trust (other than a family trust) or other legal organization (referred to as “legal organizations”) to which the adviser provides investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, member, or beneficiaries.<sup>36</sup>
- Two or more “legal organizations” as described above that have identical owners.<sup>37</sup>

Also, a hedge fund manager does not look through the following investors:

- Insurance companies

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<sup>34</sup> Release No. IA-2333, at 76

<sup>35</sup> See Rule 203(b)(3)-1(a)(1); Release No. IA-2333, at 75, note 248.

<sup>36</sup> Rule 203(b)(3)-1(a)(2)(i) under the Advisers Act.

<sup>37</sup> Rule 203(b)(3)-1(a)(2)(ii) under the Advisers Act.

- Broker-dealers
- Banks<sup>38</sup>

Additionally, a hedge fund manager would not look through a non-U.S. domiciled pooled investment vehicle if the interests in such offshore fund are offered only to non-U.S. investors because such fund is not relying on Section 3(c)(1) or 3(c)(7) of the Company Act and therefore, such investment vehicle is not a “private fund.” As such, a non-U.S. domiciled pooled investment vehicle that only has non-U.S. investors and is not relying on Section 3(c)(1) or 3(c)(7) of the Company Act is to be treated as one client.

Note, if an individual invests in two private funds advised by the same hedge fund manager, that individual is counted only once toward the 14-client threshold.<sup>39</sup>

### 3. Excluded from the 14-Client Threshold

A hedge fund manager does not count the following investors towards the 14-client threshold for the purposes of Rule 203(b)(3)-2 under the Advisers Act:

- The hedge fund manager itself in its capacity as a general partner to a limited partnership or managing member to a limited liability company;<sup>40</sup>
- Inside personnel of the hedge fund manager that invest in the “private fund” and that satisfy the “knowledgeable employee” definition as described in Rule 205-3(d)(1)(iii) under the Advisers Act.<sup>41</sup>

## **C. Assets under Management**

### 1. Threshold - U.S.\$25 Million/\$U.S.30 Million

A hedge fund manager must have at least U.S.\$25 million of assets under management to be eligible to register with the SEC.<sup>42</sup> Note that at U.S. \$25 million or more of assets under management, it is permissible for a hedge fund manager to register with the SEC, but it is not mandatory.

It becomes mandatory for a hedge fund manager to register with the SEC if it has U.S.\$30 million or more of assets under management (presuming that all other conditions under Rule 203(b)(b)-2 under the Advisers Act are satisfied).

### 2. Excluded from the Assets under Management Calculation

The following may be excluded for the purposes of determining the amount of assets under management:

<sup>38</sup> Release No. IA-2333, at 70.

<sup>39</sup> Release no. IA-2333, at 75, note 248.

<sup>40</sup> Rule 203(b)(3)-2(a) under the Advisers Act; Release No. IA-2333, at 60, note 193.

<sup>41</sup> Rule 203(b)(3)-2(a) under the Advisers Act.

<sup>42</sup> Section 203(a)(1)(A) of the Advisers Act.

- Family assets
- Proprietary capital of the hedge fund manager
- Capital contributions from inside personnel of the hedge fund manager
- Assets attributable to non-U.S. investors<sup>43</sup>

### **III. Consequences of Having to Register with the SEC**

#### **A. Form ADV**

A hedge fund manager that is required to register with the SEC will be required to respond to part 1A, Item 7 and complete Section 7.B. of Schedule D in Part I of Form ADV.<sup>44</sup>

##### 1. Part 1A, Item 7

A hedge fund manager is to respond affirmatively that it advises a “private fund.”

##### 2. Section 7.B. of Schedule D

The hedge fund manager must disclose the following for each private fund that it advises:

- The name of the private fund.
- The name of the general partner or manager of the private fund.
- Respond whether clients are solicited to invest in the private fund.
- The percentage of its clients that have invested in the private fund.
- The minimum investment commitment required of a limited partner, member or other investor.
- The current value of the total assets of the private fund.

Note that disclosure of each “private fund” is not limited to the private funds that the hedge fund manager directly operates but also includes each “private fund” that a “related person” of the fund manager advises.<sup>45</sup>

<sup>43</sup> Release No. IA-2333, at 60, notes 191 and 195.

<sup>44</sup> See Appendix A to this memorandum.

<sup>45</sup> Release No. IA-2333, at 128. In the Form ADV, a “related person” is defined to mean any “advisory affiliate” and any person that is under “common control” with the adviser. An “advisory affiliate” is (1) all of the adviser’s officers, partners, or directors (or any person performing similar functions); (2) all person directly or indirectly controlling or controlled by the adviser; and (3) all current employees (other than employees performing only clerical, administrative, support or similar functions). “Control” means the power, directly or indirectly, to direct the management policies of a person, whether through ownership of

Hedge fund managers that are *currently registered* will have to complete Item 7.B. of Schedule D in Part I of Form ADV starting on March 8, 2005 and must in any event respond to Item 7.B. by February 1, 2006.<sup>46</sup>

## **B. Compliance with the Advisers Act – Certain Rules to Consider**

A hedge fund manager that is registered as an investment adviser with the SEC is required to comply with the various provisions under the Advisers Act. Tannenbaum Helpern has prepared a separate memorandum that provides an overview of compliance with the Advisers Act.<sup>47</sup> In this memorandum, we are highlighting critical policies and procedures that hedge fund managers will have to develop and adopt if they are required to register with the SEC.

### 1. Written Compliance Program (Rule 206(4)-7 under the Advisers Act)<sup>48</sup>

The key provision that a registered hedge fund manager will have to comply with is Rule 206(4)-7 under the Advisers Act which requires a registered investment adviser to adopt a written compliance program that addresses compliance with the various provisions under the Advisers Act and to appoint a Chief Compliance Officer who is responsible for implementing and administering the written compliance program.

According to the SEC, the written compliance program must address the following:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the investment adviser and applicable regulatory restrictions;<sup>49</sup>
- Trading practices, including procedures by which the investment adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services (soft dollar arrangements) and allocates aggregated trades among clients;<sup>50</sup>

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securities, contract, or otherwise. An adviser's officers, partners, or directors exercising executive responsibility is presumed to control the adviser. Also, a person is presumed to control the adviser if the person owns a twenty-five percent interest in the adviser. A "person" is a natural person or a company (partnership, corporation, trust, limited liability company, limited liability partnership or other organization). See Glossary of Terms to Form ADV.

<sup>46</sup> Release No. IA-2333, at 84.

<sup>47</sup> We have prepared a separate memorandum that provides an overview of compliance with the requirements imposed by the Advisers Act and other statutes entitled "Compliance and Filing Requirements for Fund Managers that Are Registered Investment Advisers" (December 2004).

<sup>48</sup> See Securities and Exchange Commission; "Compliance Programs of Investment Companies and Investment Advisers"; final rule. 68 Fed. Reg. 74714-74730 (December 24, 2003). We have prepared a more comprehensive discussion on compliance with the written compliance program in a separate memorandum entitled "SEC Adopts Final Rules Requiring Registered Investment Advisers to Implement Written Compliance Program" (January 7, 2004).

<sup>49</sup> A registered investment adviser that votes proxies on behalf of its clients is required to adopt and to implement written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients. See Rule 206(4)-6 under the Advisers Act.

<sup>50</sup> An investment adviser that engages in the use of soft dollars (whether within the exceptions under Section 28(e) of the Securities Exchange Act of 1934 or outside Section 28(e)) is required to disclose its

- Proprietary trading of the investment adviser and personal trading activities of supervised persons;<sup>51</sup>
- The accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements;<sup>52</sup>
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;<sup>53</sup>
- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;<sup>54</sup>
- Marketing advisory services, including the use of solicitors;<sup>55</sup>
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information;<sup>56</sup> and
- Business continuity plans.<sup>57</sup>

## 2. Code of Ethics (Rule 204A-1 under the Advisers Act)<sup>58</sup>

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soft dollar practices to clients and should internally document and periodically review how it allocates soft dollars for research and other services to demonstrate its compliance with the best execution obligations. See Securities and Exchange Act Release No. 23170 (Apr. 23, 1986).

<sup>51</sup> Pursuant to Section 204A of the Advisers Act, registered investment advisers are required to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the investment adviser and any of its associated persons from misusing material, nonpublic information. Also, pursuant to Rule 204-2(a)(12) under the Advisers Act, a registered investment adviser is required to maintain policies and procedures that address, report, and review the personal securities transactions of its employees and their family members.

<sup>52</sup> The advertising of a registered investment adviser's services and its performance results are governed by Rule 206(4)-1 under the Advisers Act and by a series of SEC no-action letters. See e.g. Gallagher and Associates, Ltd. (July 10, 1995) (prohibition on testimonials); Clover Capital Management, Inc. (Oct. 28, 1986) (performance advertisement); Investment Company Institute (Aug. 24, 1987) (performance advertisement must be net of fees); JP Morgan Investment Management, Inc. (May 7, 1996) (model fees); Association for Inv. Management & Research (Dec. 18, 1996) (accounts to include in determining actual performance); Horizon Asset Mgmt, LLC (Sept. 13, 1996) (portability of past performance); and Great Lake Advisors, Inc. (Apr. 3, 1992) (portability of past performance).

<sup>53</sup> A registered investment adviser deemed to have custody is required in general to (i) maintain cash and securities with a qualified custodian and (ii) distribute account statements to each of its clients pursuant to Rule 206(4)-2 under the Advisers Act.

<sup>54</sup> In general, a registered investment adviser is required to maintain books and records with respect to its advisory services for a period of five years (the first two years on-site at the adviser's office) pursuant to Rule 204-2(e)(1) under the Advisers Act. The types of documents to be maintained are described in Rule 204-2(a)(1)-(16), Rule 204-2(b), Rule 204-2(c), and Rule 204-2(e)(2) under the Advisers Act. It is permissible to maintain such records in electronic format provided that the investment adviser can furnish a copy to the SEC within twenty-four hours. See Rule 204-2(g) under the Advisers Act; Release No. IA-1945 (May 24, 2001).

<sup>55</sup> A registered investment adviser that uses a third-party to solicit clients, i.e., a finder, must comply with the procedures set forth in Rule 206(4)-3 under the Advisers Act. See discussion on the Solicitation Rule.

<sup>56</sup> A registered investment adviser is required to adopt a written policy that describes how such an investment adviser maintains and protects the nonpublic personal information of its natural person clients and to provide such clients with a written notice of the investment adviser's privacy policy pursuant to Regulation S-P.

<sup>57</sup> Interestingly, the adoption of a business continuity plan is now a fiduciary obligation even though this requirement is not explicitly stated in the Advisers Act. According to the SEC, an investment adviser's fiduciary obligation includes the obligation to take steps to protect its clients' interests from being placed at risk as a result of such an investment adviser's inability to provide advisory services after a natural disaster or the death or the owner or key personnel. See 68 Fed. Reg. at 74716, note 22.

A hedge fund manager that is a registered investment adviser is required to adopt and to enforce a Code of Ethics applicable to its supervised persons.<sup>59</sup> The Code of Ethics is to cover the following issues:

- Standards of business conduct that are expected of supervised persons and that reflect the adviser’s fiduciary duties;
- An agreement to comply with all applicable securities laws;
- Written acknowledgement by all “supervised persons” that they acknowledge receipt of the written Code of Ethics;
- Provisions to prevent disclosure of material nonpublic information about securities recommendations, holdings and transactions;
- Provisions on personal securities reporting by “access persons”<sup>60</sup>; and
- Pre-clearance requirements for “access persons” of any personal investments in IPOs and private placements.

“Access persons” are required to submit the following to the Chief Compliance Officer:

(a) Initial Holdings Reports

An “access person” must complete an initial report of his or her reportable securities holdings at the time the person becomes an “access person.” The initial report must be submitted to the Chief Compliance Officer no later than ten (10) days after the person becomes an “access person” of a registered investment adviser.

(b) Annual Holdings Reports

On an annual basis, a registered investment adviser’s “access person” must complete a report of his or her reportable securities and submit it to the Chief Compliance Officer.

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<sup>58</sup> See Securities and Exchange Commission; “Investment Adviser Code of Ethics”; final rule. 69 Fed.Reg. 41696-41709 (July 9, 2004). We have prepared a more comprehensive discussion on compliance with the Code of Ethics in a separate memorandum entitled “SEC Adopts New Rule 204A-1 under the Advisers Act – Registered Investment Advisers Are Required to Adopt a Code of Ethics” (July 14, 2004).

<sup>59</sup> The term “supervised person” refers to the adviser’s partners, officer, directors (or other person occupying a similar status or performing similar functions) and employees, as well as any other persons who provide advice on behalf of the adviser and are subject to the adviser’s supervision and control. See Section 202(a)(25) of the Advisers Act.

<sup>60</sup> The term “access person” is a functional definition that refers to any supervised person that performs the following functions:

- has access to nonpublic information regarding any clients’ purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund; or
- is involved in making securities recommendations to clients, or has access to such recommendations that are nonpublic.

See Rule 204A-1(e)(1)(i)(A) and (B) under the Advisers Act.

The annual holdings report must be current as of a date no more than forty-five (45) days prior to the date the annual report was submitted

(c) Quarterly Transaction Reports

“Access persons” must submit transaction reports of all personal securities transactions on a quarterly basis to the Chief Compliance Officer. Such quarterly transaction reports must be due no later than thirty (30) days after the close of the calendar quarter.

As an alternative to submitting quarterly transaction reports, registered investment advisers may continue to require persons who are “access persons” to submit brokerage statements or trade confirmations as long as such documents contain the information required under Rule 204A-1(b)(2)(i)(A)-(E) under the Advisers Act. Moreover, such statements or confirmations must be received by the investment adviser no later than thirty (30) days after the close of the calendar quarter in which the transaction takes place.

3. Solicitation Rule (Rule 206(4)-3 under the Advisers Act)

A hedge fund manager that is registered with the SEC and compensates third-parties that find investors to invest in its fund(s) is required to comply with Rule 206(4)-3 under the Advisers Act. Rule 206(4)-3 under the Advisers Act states that any cash referral fee must be paid pursuant to a *written agreement* to which the investment adviser is a party. This written agreement must describe the solicitor’s activities and its compensation for those activities and contain the solicitor’s undertaking to perform those duties under the agreement consistent with the fund manager’s instructions and the Advisers Act and rules thereunder.

The separate written disclosure document must contain basic information relating to the solicitation (including the names of the solicitor and the investment adviser, the nature of the relationship or affiliation between the adviser and the solicitor, a description of the terms of the compensation and the amount the client is being charged in addition to the advisory fee as a consequence of the solicitation agreement).

In addition, a registered hedge fund manager must receive from the investor, *prior to, or at the time of, entering into any written or oral investment advisory contract with such investor* a signed and dated acknowledgement showing that the investor received (i) the investment adviser’s written disclosure statement and (ii) the solicitor’s written disclosure document. Finally, the registered fund manager must make a bona fide effort to ascertain that the solicitor has complied with the terms of the agreement between the parties and must have a reasonable basis for believing that the solicitor has complied.

It is paramount that a hedge fund manager obtain and maintain the written acknowledgements from investors who have been solicited by third-parties because the SEC is requiring hedge fund managers to affirmatively disclose whether any investor has

been solicited by third parties.<sup>61</sup> Hedge fund managers registered with the SEC should expect examiners to request copies of written acknowledgements of investors during SEC examinations if they have responded that investors are solicited by third parties.

#### 4. Valuation

According to the SEC, a registered investment adviser's compliance program must address the processes of valuing client holdings.<sup>62</sup> What this requirement likely means to registered hedge fund managers is that the fund manager must adopt a policy that details how such a fund manager values the positions in the hedge fund's portfolio and, depending on the circumstances, perhaps hire an independent third party to serve as a check with respect to the valuation of a fund's portfolio. The SEC staff feels that the lack of independent checks on a hedge fund adviser's valuation of a hedge fund's portfolio is among the most serious concerns the SEC staff has identified in the course of their investigation of the hedge fund industry.<sup>63</sup> Moreover, the SEC staff is particularly concerned with the valuation of illiquid securities in a hedge fund's portfolio.<sup>64</sup> Furthermore, the SEC staff has found that hedge fund advisers have broad discretion to value securities and often exercise ultimate judgement over valuation.<sup>65</sup> In light of the absence of any form of independent oversight over hedge fund pricing, the quality and fairness of the prices of a hedge fund's portfolio seems suspect from the perspective of the SEC staff.

What the SEC expects from registered investment advisers that are hedge fund managers with respect to valuation remains an open question. The SEC has yet to issue any concrete guidelines on valuation despite the SEC staff's critical commentary of hedge fund valuation. Until the SEC releases concrete guidance, hedge fund managers should strongly consider obtaining valuations from third parties such as two or three prime brokers. A hedge fund manager that elects to value holdings in its portfolio on its own without relying on third parties should adopt a robust policy that justifies how it reached its values because it is likely that the SEC staff will closely scrutinize such a fund manager during a SEC examination.

#### 5. Qualified Clients (Rule 205-3(d)(1) under the Advisers Act)

##### *(a) Current Investors that Are Not Qualified Clients Are "Grandfathered"*

A registered investment adviser is prohibited from charging its clients a performance fee or performance allocation pursuant to Section 205(a)(1) of the Advisers Act unless *inter alia* its clients are "qualified clients" as defined in Rule 205-3(d)(1) under the Advisers

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<sup>61</sup> See Section 7.B., Schedule D of Part I of Form ADV.

<sup>62</sup> 68 Fed. Reg. at 74716.

<sup>63</sup> See Part VI.B. of the "Implications of the Growth of Hedge Funds," Staff Report to the SEC (September 2003) (the "SEC Staff Hedge Fund Report").

<sup>64</sup> See Parts IV.G. and VI.B. of the SEC Staff Hedge Fund Report.

<sup>65</sup> See Parts IV.G. and VI.B. of the SEC Staff Hedge Fund Report.

Act.<sup>66</sup> However, unregistered investment advisers are not subject to this restriction.<sup>67</sup> Accordingly, unregistered hedge fund managers that operate 3(c)(1) funds have been able to charge a performance fee or a performance allocation without requiring investors to satisfy the “qualified client” standard. However, registration as an investment adviser with the SEC would require these hedge fund managers to require investors to be “qualified clients” if they wish to continue to charge a performance fee or allocation.

In recognition of the potentially disruptive effect on pre-existing investor relationships, the SEC has adopted proposed Rule 205-3(c)(2) to permit current investors in a “private fund” that are not qualified clients (as such term is defined in Rule 205-3(d)(1) under the Advisers Act) to be grandfathered into the “private fund” so that the investors may remain in the fund and that the registered fund manager may continue to charge them a performance fee or performance allocation.<sup>68</sup> Also, a “grandfathered investor” is permitted to make additional contributions to the fund that it is an investor in without having to satisfy the qualified client criteria.<sup>69</sup>

Furthermore, the grandfathering of current clients extends to clients in managed accounts of the hedge fund manager.<sup>70</sup>

Note that if a hedge fund manager that is required to register under Rule 203(b)(3)-2 under the Advisers Act offers a new 3(c)(1) fund and a “grandfathered investor” in an existing 3(c)(1) fund wishes to invest in the new 3(c)(1) fund, such a “grandfathered investor” is required to satisfy the qualified client criteria described in Rule 205-3(d)(1) under the Advisers Act.<sup>71</sup>

#### *(b) Impact on Hedge Fund Managers of 3(c)(1) Funds that Are Now Required to Register*

A hedge fund manager of an existing 3(c)(1) fund that charges its investors a performance fee or allocation will have to amend its offering documents to require new investors that invest in such fund after February 10, 2005 to be qualified clients.

Also, if such hedge fund manager accepts an investor which itself is a 3(c)(1) fund after February 10, 2005, then the fund manager will have to require each beneficial owner of the investing 3(c)(1) fund to be a qualified clients because Rule 205-3(b) permits a performance fee or performance allocation to be charged to another private investment vehicle which itself is exempt from registration under Section 3(c)(1) of the Company Act only if each beneficial owner of such investment vehicle is a qualified client.<sup>72</sup>

#### *(c) Qualified Client Rule Does Not Apply to Offshore Funds*

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<sup>66</sup> Rule 205-3(a) under the Advisers Act.

<sup>67</sup> Section 205(a) under the Advisers Act.

<sup>68</sup> See 69 Fed. Reg. at 45186, note 156.

<sup>69</sup> Release No. IA-2333, at 79.

<sup>70</sup> Release No. IA-2333, at 79.

<sup>71</sup> Rule 205-3(c)(3) under the Advisers Act.

<sup>72</sup> See Rules 205-3(b) and 205-3(d)(3) under the Advisers Act.

A registered investment adviser, whether located within the U.S. or outside the U.S., that operates an offshore fund is not subject to the prohibition on performance fees. According to the SEC staff, a registered investment adviser can charge performance fees to a non-U.S. domiciled fund *regardless* of whether such fund has U.S. investors.<sup>73</sup>

## 6. Past Performance

The SEC is adopting the proposal that will permit hedge fund managers that have been exempt from registration in reliance on Section 203(b)(3) of the Advisers Act but are now required to register with the SEC to use past performance information relating to the period prior to February 10, 2005 without being subject to the requirements that such advisers maintain records supporting the performance information of the “private fund” or managed account.<sup>74</sup>

## 7. Books and Records of Related Entities

In recognition that most U.S.-domiciled funds are structured so that there is a general partner or managing member and an investment manager, the books and records of any “private fund” are considered to be the books and records of the entity that is the registered investment adviser.<sup>75</sup>

# **IV. Impact of the Final Rules on Non-U.S. Based Hedge Fund Managers**

## **A. When Does A Non-U.S. Based Hedge Fund Manager Have to Register with the SEC**

A non-U.S. based hedge fund manager is to apply the following two-tier test: (i) does the hedge fund manager operate a “private fund”; and (ii) are there fifteen or more U.S. clients. As such, if a non-U.S. based hedge fund manager is operating a pooled investment vehicle that satisfies the definition of “private fund,” then the non-U.S. based fund manager is to “look through” the fund to determine if it has fifteen or more U.S. clients. Subsequently, if there are fifteen or more U.S. clients, then the non-U.S. based fund manager must register as an investment adviser with the SEC *without regard* to its assets under management (the U.S.\$30 million assets under management requirement does not apply).<sup>76</sup>

### 1. Operates a “Private Fund”

A pooled investment vehicle is defined to be a “private fund” if it satisfies the three elements:

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<sup>73</sup> Release No. IA-2333, at 68, note 221.

<sup>74</sup> See Rule 204-2(e)(3)(ii) under the Advisers Act.

<sup>75</sup> Rule 204-2(I) under the Advisers Act.

<sup>76</sup> Release No. IA-2333, at 59.

A company:

- (i) that would be an investment company under Section 3(a) of the Investment Company Act but for the exception provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of such Act;
- (ii) that permits owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and
- (iii) interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.<sup>77</sup>

Of the three elements, the key factor non-U.S. hedge fund managers must be cognizant of is whether the fund that they operate relies on Section 3(c)(1) or 3(c)(7) of the Company Act. In practical terms, if a non-U.S. based hedge fund manager is operating a Delaware-registered limited partnership or limited liability company that is relying on either Section 3(c)(1) or 3(c)(7) of the Company Act, then (presuming that the two-year redemption test is satisfied) the non-U.S. based fund manager is operating a “private fund” and must subsequently “look through” and count U.S. clients to determine if registration with the SEC is required.

Additionally, if the non-U.S. based investment adviser is operating a non-U.S. domiciled fund and is offering interests of the non-U.S. domiciled fund to U.S. investors in reliance on Section 3(c)(1) or 3(c)(7) of the Company Act, then (presuming that the two-year redemption test is satisfied), the non-U.S. based fund manager is operating a “private fund” and must subsequently “look through” and count U.S. clients to determine if registration with the SEC is required.

## 2. U.S. Clients

If a non-U.S. based fund manager is operating a “private fund,” the next step is to look through the “private fund” to determine the number of U.S. clients. Only U.S. residents are to be counted; non-U.S. investors are excluded from the calculation. The test to determine who is a “U.S. resident” is the following:

- Individuals – their residence
- Corporations and other business entities – the principal office and place of business
- Personal trusts and estates – the rules under Regulation S of the Securities Act of 1933 (any trust in which any trustee is a U.S. person; any estate of which any executor or administrator is a U.S. person)
- Discretionary or non-discretionary accounts managed by another investment adviser – the location of the person for whose benefit the account is held.<sup>78</sup>

When an investor is a pooled investment vehicle, it is a corporation or other business entity, and therefore, the non-U.S. fund manager should look at the pooled investment

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<sup>77</sup> See Section 203(b)(3)-1(d) of the Advisers Act.

<sup>78</sup> Release No. IA-2333, at 63, note 201.

vehicle's principal office and place of business to determine if the pooled investment vehicle is a U.S. resident.<sup>79</sup> What this means in practice is if an investor is a Delaware-domiciled limited partnership or limited liability company, a non-U.S. fund manager is to treat such investor as a U.S. client. Moreover, if such Delaware-domiciled investment vehicle is a "private fund," a "private fund" that is a fund-of-funds, or a registered investment company that is a fund-of-funds, the non-U.S. fund manager is to look-through this investment vehicle and attribute any U.S. persons who are investors in the investment vehicle towards the 14-U.S. client threshold.

Note that the determination as to whether an investor is a U.S. client or a non-U.S. client is made at the time of the investment in the "private fund."<sup>80</sup> If an investor is a non-U.S. client at the time of the investment, the fund manager may continue to count the investor as a non-U.S. client even if the investor subsequently relocates to the United States.<sup>81</sup> *However, if the non-U.S. client who relocates to the United States makes a subsequent investment, such investor is treated as a U.S. client towards the 14-U.S. client threshold.*<sup>82</sup>

Finally, if a non-U.S. investor transfers his interest to a U.S. investor, the fund manager is to count the transferee as a U.S. client.<sup>83</sup>

## **B. Extent of Compliance with the Advisers Act by Non-U.S. Based Registered Investment Adviser**

### 1. Applicable Rules

In general, the substantive provisions of the Advisers Act do not apply to non-U.S. based registered advisers.<sup>84</sup> However, a non-U.S. based registered fund manager remains obligated to comply with certain provisions under the Advisers Act:

- The recordkeeping rules, *other than* Rules 204-2(a)(3) and (7) with respect to transactions involving offshore clients that do not relate to advisory services performed by the registered adviser on behalf of U.S. client or related securities transactions
- The recordkeeping rules, *other than* Rules 204-2(a)(8), (9), (10), (11), (14), (15) and (16) and Rule 204-2(b) with respect to transactions involving, or representations or disclosures made to non-U.S. clients
- The Code of Ethics to the extent the non-U.S. based adviser must retain its access persons' personal securities reports (Rule 204A-1 under the Advisers Act)

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<sup>79</sup> Release No. IA-2333, at 63, note 201.

<sup>80</sup> Rule 203(b)(3)-1(b)(7) under the Advisers Act.

<sup>81</sup> Release No. IA-2333, at 64.

<sup>82</sup> Telephone call with Jamey Basham, Branch Chief of the Office of Investment Adviser Regulation, Division of Investment Management, SEC (December 8, 2004).

<sup>83</sup> Release No. IA-2333, at 64, note 203.

<sup>84</sup> Release No. IA-2333, at 66.

Also, the SEC is permitting non-U.S. based registered advisers to represent themselves as registered with the SEC, however, non-U.S. based registered advisers should note that they remain subject to the anti-fraud provisions under the Advisers Act.<sup>85</sup>

A non-U.S. based hedge fund manager that registers with the SEC remains subject to examination by the SEC staff.<sup>86</sup> During the examination, the registered non-U.S. based adviser must provide to the SEC staff any and all records required to be kept under the Advisers Act *as well as* any records the adviser keeps under its home jurisdiction.<sup>87</sup>

An issue that needs to be clarified is the extent a non-U.S. based adviser must comply with the substantive provisions of the Advisers Act if it operates a U.S.-domiciled pooled investment vehicle. According to the SEC staff, the extraterritorial application of the Advisers Act is limited under Rule 203(b)(3)-2(c) under the Advisers Act in situations when the adviser's principal place of business is outside the United States and if the fund is organized under the laws of a country other than the United States.<sup>88</sup> The condition that a pooled investment vehicle must be domiciled outside the U.S. implies that the limitation of the extraterritorial application of the Advisers Act would not apply if the non-U.S. domiciled fund manager is operating a U.S.-domiciled fund. As such, a non-U.S. based fund manager that is operating a U.S.-feeder that has fifteen or more U.S. clients and is therefore required to register with the SEC could potentially be exposed to full compliance with the Advisers Act. If full compliance with the Advisers Act is the result, non-U.S. based fund managers may close the door on U.S. investors that invest in U.S. feeders at fourteen U.S. investors.

## 2. Excluded from Compliance with the Advisers Act

Significantly, the SEC staff has delineated which provisions are inapplicable to non-U.S. based registered advisers with respect to their non-U.S. clients. Non-U.S. based registered advisers that operate non-U.S. domiciled are not required to comply with the following:

- The written compliance program (Rule 206(4)-7 under the Advisers Act)<sup>89</sup>
- The custody rule (Rule 206(4)-2 under the Advisers Act)
- The proxy voting rule (Rule 206(4)-6 under the Advisers Act)
- The advertising rule (Rule 206(4)-1 under the Advisers Act)
- The solicitation rule with respect to non-U.S. investors (Rule 206(4)-3 under the Advisers Act)<sup>90</sup>

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<sup>85</sup> Release No. IA-2333, at 67, note 215.

<sup>86</sup> Release No. IA-2333, at 67.

<sup>87</sup> Release No. IA-2333, at 67, note 217. Section 204 of the Advisers Act authorizes the SEC examine **all records** of any registered adviser. *Id.*

<sup>88</sup> Rule 203(b)(3)-2(c) under the Advisers Act; Release No. IA-2333, at 66, note 210.

<sup>89</sup> By being excluded from complying with Rule 206(4)-7 under the Advisers Act, this exclusion implies that various provisions that the SEC staff expects a written compliance program to address do not apply and that the non-U.S. based adviser is not required to appoint a chief compliance officer.

- The “brochure rule” with respect to both U.S. investors and non-U.S. investors (Rule 204-3 under the Advisers Act)<sup>91</sup>

The rationale for this exclusion is the SEC’s position that the non-U.S. based fund manager may treat its non-U.S. domiciled “private fund” (and not the investors) as its client for most purposes under the Advisers Act.<sup>92</sup>

### **C. Non-U.S. Based Advisers to Non-U.S. Domiciled Publicly Offered Funds**

A pooled investment vehicle whose principal office and place of business is outside the United States is not a “private fund” if such investment vehicle makes a public offering of its securities in a country outside the United States and the investment vehicle is regulated as a public investment company under the laws of at least one country outside the United States where interests are offered to the public.<sup>93</sup> The exception from the definition of “private fund” applies to any publicly offered fund so long as the fund is authorized for sale in the same jurisdiction in which it is regulated as a public company.<sup>94</sup> Such publicly offered funds may have fifteen or more U.S. clients and the fund manager remains exempt from registration with the SEC.

The SEC notes that in some jurisdictions hedge funds may be publicly offered. However, such funds would not be public funds for purposes of Rule 203(b)(3)-2 under the Advisers Act.<sup>95</sup>

## **V. Amendments to the Custody Rule (Rule 206(4)-2 under the Advisers Act)**

### **A. Amended Rule 206(4)-2(b)(3) under the Advisers Act**

The SEC amended Rule 206(4)-2 under the Advisers Act to permit registered investment advisers that are operators of fund-of-funds that are deemed to have custody to distribute financial statements audited in accordance with U.S. generally accepted accounting principles within 180 days after a pooled investment vehicle’s fiscal year end to each beneficial owner in the investment vehicle in lieu of distributing account statements on a quarterly basis.<sup>96</sup> The extension from the original 120 days rule is a recognition by the SEC that a fund-of-fund’s annual financial statement is dependent on the underlying

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<sup>90</sup> A non-U.S. based investment adviser that uses a third-party to solicit U.S. investors is required to obtain and maintain written acknowledgements from U.S. investors in accordance with Rule 206(4)-3 under the Advisers Act.

<sup>91</sup> “[W]e would not require an offshore adviser to deliver a written disclosure brochure to its offshore clients (or to any investors in an offshore private fund it advises) under Rule 204-3 ...” Release No. IA-2333, at 67, note 221.

<sup>92</sup> Release No. IA-2333, at 65-66.

<sup>93</sup> Release No. IA-2333, at 64-65, note 208.

<sup>94</sup> Release No. IA-2333, at 65.

<sup>95</sup> Release no. IA-2333, at 65, note 209.

<sup>96</sup> Rule 206(4)-2(b)(3) under the Advisers Act.

portfolio fund to distribute its own annual financial statement.<sup>97</sup> Realistically, an operator of a fund-of-funds needs more time to distribute audited financial statements if the operator is to rely on Rule 206(4)-2(b)(3) under the Advisers Act as a means to comply with the custody rule.

*Note that the extension to 180 days applies only to pooled investment vehicles that are fund-of-funds. A “fund-of-funds” is defined to mean “a limited partnership (or limited liability company, or another type of pooled investment vehicle) that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person (as defined in Form ADV (17 CFR 279.1)) of the limited partnership, its general partner, or its adviser.”*<sup>98</sup>

A registered investment adviser that is an operator of a pooled investment vehicle that is not a fund-of-funds must distribute the pooled investment vehicle’s audited financial statements within 120 days after the investment vehicle’s fiscal year end if such an operator wishes to rely on Rule 206(4)-2(b)(3) under the Advisers Act in lieu of distributing account statements on a quarterly basis.<sup>99</sup>

## **B. How Does a Hedge Fund Manager that Is a Registered Investment Adviser Know It Has Custody**

### 1. U.S.-Domiciled Funds

In Release No. IA-2333, the SEC staff reinforced its position that by virtue of its position as an adviser to a pooled investment vehicle, such an adviser is deemed to have custody by stating:

“An adviser acting as general partner to a pooled investment vehicle it manages, including a hedge fund, has custody of the pool’s assets.”<sup>100</sup>

Accordingly, in the context of U.S.-domiciled funds, a hedge fund manager acting as the general partner to limited partnership or as the managing member to a limited liability company is deemed to have custody and therefore must comply with the custody rule under Rule 206(4)-2 under the Advisers Act.

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<sup>97</sup> See Release No. IA-2333 at 80.

<sup>98</sup> Rule 206(4)-2(c)(4) under the Advisers Act.

<sup>99</sup> Rule 206(4)-2(b)(3) under the Advisers Act.

<sup>100</sup> Release No. IA-2333, note 265. Note that this is not the exclusive test to determine whether a registered investment adviser has custody. The SEC staff has set forth other tests to determine whether a registered investment adviser has custody in the release adopting amendments to the custody rule. According to the SEC, a registered investment adviser is deemed to have custody when (1) it has possession of client funds or securities, even briefly (not including inadvertent receipt if returned to sender within three business days); (2) it has authority to withdraw funds or securities or obtain possession of them or can direct a third party to do so; or (3) it acts in any capacity that gives it legal ownership of or access to, the client funds or securities. See Rule 206(4)-2(c)(1)(i)-(iii) under the Advisers Act; Securities and Exchange Commission; “Custody of Funds or Securities of Clients by Investment Advisers; final rule. 68 Fed. Reg. 56692-56701, at 56692-56693 (October 1, 2003).

## 2. Non-U.S. Domiciled Funds

In the context of non-U.S. domiciled funds, a hedge fund manager that is the investment manager to an offshore fund would have custody if (1) it has possession of client funds or securities, even briefly (not including inadvertent receipt if returned to sender within three business days); (2) it has authority to withdraw funds or securities or obtain possession of them or can direct a third party to do so; or (3) it acts in any capacity that gives it legal ownership of or access to, the client funds or securities. Even if any of these three conditions are not met, based on the results of SEC staff examinations of our clients, the SEC staff position is that if a member of the investment adviser is acting as one of the directors of the non-U.S. domiciled fund, the SEC may deem the investment adviser to have custody because the position of being a director gives that person the power to direct funds and securities and therefore such a person can potentially abscond with the funds and securities.

## 3. Compliance with the Custody Rule<sup>101</sup>

A hedge fund manager that is registered and is deemed to have custody will have to do the following:

- (i) appoint a qualified custodian to maintain its client's assets and securities in a separate account for each client under that client's name **or** in accounts that contain only its client's funds and securities, under the fund manager's name as agent or trustee for the client,
- (ii) distribute a notice to each investor in the fund regarding the qualified custodian's contact information and the manner in which the assets and securities are held, **and**
- (iii) comply with one of the following:
  - A. distribute on a quarterly basis account statements that disclose (i) the amount of funds the client has with the fund manager, (ii) each security in the account as of the end of each period, and (iii) all transactions in the account during that period; **or**
  - B. distribute financial statement audited in accordance with GAAP within 120 days of the pooled investment vehicle's fiscal year end, or in the case of fund-of-funds within 180 days of the investment vehicle's fiscal year end.

Note that a hedge fund manager that elects to have account statements distributed on a quarterly basis may (i) have its qualified custodian distribute the account statement or (ii)

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<sup>101</sup> We have prepared a more comprehensive discussion on compliance with the custody rule in a separate memorandum entitled "SEC Adopts Amendments to Custody Rule under Investment Advisers Act of 1940" (October 2003).

choose to distribute the account statements directly and be subject to the additional requirement that an independent auditor conduct a surprise audit.<sup>102</sup>

Further note that a hedge fund manager that is currently unregistered and must now register with the SEC must comply with the custody rule, i.e., appoint a qualified custodian to hold cash and securities and distribute notice to investors of the fund(s) by February 1, 2006.<sup>103</sup>

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If you have any questions or comments regarding the adoption of Rule 203(b)(3)-2 under the Advisers Act, amendments to the Advisers Act or compliance with the Advisers Act, please feel free to contact:<sup>104</sup>

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<sup>102</sup> This surprise audit is conducted by the fund manager's own independent public accountant on an annual basis at a different time each year and with no notice to the fund manager. The accountant who conducts the surprise audit must report findings to the SEC within 30 days of completion of the audit by filing an ADV-E with the SEC.

<sup>103</sup> Release No. IA-2333, at 83.

<sup>104</sup> For further information about recent rules and developments applicable to registered investment advisers, please see *SEC Releases Proposed Rules to Require Hedge Fund Managers to Register with the SEC; Chairman Donaldson Defends Proposed Rules; SEC Adopts New Rule 204A-1 of the Advisers Act – Registered Investment Advisers Are Required to Adopt a Code of Ethics; Registered Investment Advisers Are Now Expected to Retain E-Mail; SEC Permits Registered Investment Advisers to Provide Past Specific Recommendations in Response to Unsolicited Requests for Information; SEC Adopts Final Rules Requiring Registered Investment Advisers to Implement Written Compliance Program; SEC Adopts Amendments to Custody Rule under Investment Advisers Act of 1940; and New Proxy Voting Rules and Amendments to Current Rule Requiring Registered Investment Advisers to Maintain Certain Books and Records under the Investment Advisers Act of 1940*, available on our website. See [www.tannenbaumlaw.com](http://www.tannenbaumlaw.com)

Appendix A

Amendment to Part 1A, Item 7 of Form ADV

Item 7 Financial Industry Affiliations

\* \* \* \* \*

B. Are you or any related person a general partner in an investment-related limited partnership or manager of an investment-related limited liability company, or do you advise any other "private fund," as defined under SEC rule 203(b)(3)-1?

Yes  No

If "yes," for each limited partnership, limited liability company, or (if applicable) private fund, complete Section 7.B. of Schedule D. If, however, you are an SEC-registered adviser and you have related persons that are SEC-registered advisers who are the general partners of limited partnerships of the managers of limited liability companies, you do not have to complete Section 7.B. of Schedule D with respect to those related advisers' limited partnerships or limited liability companies.

To use this alternative procedure, you must state in the Miscellaneous Section of Schedule D: (1) that you have related SEC-registered investment advisers that manage limited partnerships or limited liability companies that are not listed in Section 7.B. of your Schedule D; (2) that complete and accurate information about those limited partnerships or limited liability companies is available in Section 7.B. of Schedule D of the Form ADVs of your related SEC-registered advisers; and (3) whether your clients are solicited to invest in any of those limited partnerships of limited liability companies.

\* \* \* \* \*

Amendment to Schedule D, Section 7.B. of Form ADV

Schedule D

\* \* \* \* \*

SECTION 7.B. Limited Partnership or Other Private Fund Participation

You must complete a separate Schedule D Page 4 for each limited partnership in which you or a related person is a general partner, each limited liability company for which you or a related person is a manager, and each other private fund that you advise.

Check only one box:  Add  Delete  Amend

Name of Limited Partnership, Limited Liability Company, or other Private Fund:

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Name of General Partner of Manager:

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If you are registered or registering with the SEC, is this a “private fund” as defined under SEC rule 203(b)(3)-1?       Yes     No

Are your clients solicited to invest in the limited partnership, limited liability company or other private fund?       Yes     No

Approximately what percentage of your clients have invested in this limited partnership, limited liability company, or other private fund? \_\_\_\_\_%

Minimum investment commitment required of a limited partner, member, or other investor: \$\_\_\_\_\_

Current value of the total assets of the limited partnership, limited liability company, or other private fund: \$\_\_\_\_\_