

HEDGE FUND UPDATE

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On October 26, 2004, the Securities and Exchange Commission (“SEC”) adopted new Rule 203(b)(3)-2 and certain other rule amendments under the Investment Advisers Act of 1940, as amended (the “Act”). The new rule and amendments (collectively, the “New Rules”) require hedge fund managers and other advisers to certain private investment companies exempt from registration under the Investment Company Act of 1940, as amended (the “Investment Company Act”), to register with the SEC under the Act. The New Rules are designed to provide the protections afforded by the Act to investors in private investment companies and to enhance the SEC's ability to protect the nation's securities markets.

Each adviser required to register under the New Rules must have its registration effective, and must have in place all policies and procedures required under the SEC rules, by February 1, 2006.

Morgan Lewis has one of the best regarded SEC regulatory practices in the country and a strong history of advising registered investment advisers and domestic and offshore private investment companies. Several of our attorneys have held positions at the SEC and their insights regarding various SEC legislation are invaluable. Thomas S. Harman and Thomas P. Lemke, partners in our Washington D.C. office, have both held senior positions in the SEC's Division of Investment Management. During their tenures with the SEC, both Thomas S. Harman and Thomas P. Lemke were instrumental in the creation and interpretation of the private adviser exemption which is the focal point of this discussion.

New Rules

The Act is the primary federal statute that regulates most advisers doing business in the United States and imposes certain registration, disclosure and substantive regulatory requirements on such advisers. Requirements under the Act include the filing of a Form ADV with the SEC, the delivery to clients of certain disclosure items, and compliance with regulations regarding recordkeeping, compliance policies and procedures, advertising, proxy voting, cash solicitation payments, performance fees and custody of client assets. The Act contains various exceptions and exemptions from registration, the most common of which is set forth in Section 203(b)(3). This “private adviser” exemption exempts an adviser from registration under the Act if it satisfies the following requirements: (i) the adviser has fewer than 15 clients during the preceding 12 months, (ii) the adviser does not hold itself out generally to the public as investment adviser, and (iii) the adviser does not advise any SEC-registered investment company or company that elects to be regulated as a business development company.

Advisers have historically been permitted to count each private investment company as a single client for purposes of the private adviser exemption. The New Rules, however,

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change this policy and now require advisers to count each investor of a “private fund,” as defined below. Accordingly, all advisers to private funds, including subadvisers, will now be required to look through the private funds they advise and count each investor in such funds in order to determine whether they advise fewer than 15 clients.

Definition of "Private Fund"

As stated above, advisers will now be required to look through the “private funds” they manage for purposes of counting the number of clients they advise. A “private fund” is defined under the New Rules as a company that: (i) is subject to regulation under the Investment Company Act but for the exception provided in either Section 3(c)(1) or Section 3(c)(7) thereof, (ii) permits investors to redeem or withdraw their interests in the company within two years of purchasing them, and (iii) offers interests that are based on the ongoing investment advisory skills, ability or expertise of the investment adviser. With respect to (iii) above, the SEC has cautioned advisers to not circumvent the New Rules by delegating advisory functions to subadvisers or by establishing so-called “manager of managers” structures.

Offshore Publicly Offered Funds. Certain funds will not be deemed to be private funds for purposes of the New Rules. The New Rules contain an exception to the definition of “private fund” for a company that “has its principal office and place of business outside the United States, makes a public offering of its securities outside the United States, and is regulated as a public investment company under the laws of a country other than the United States.” The New Rules clarify that this exception applies to “any type of publicly offered fund, whether in corporate, trust, contractual or other form, so long as the fund is authorized for sale in the same jurisdiction in which it is regulated as a public investment company.” Accordingly, certain publicly offshore offered funds, such as those that meet the UCITS requirements of the securities regulatory authority of a European Union member state, will not be deemed a private fund and can therefore be counted as a single client for purposes of the Act.

Counting Investors of Private Funds

The New Rules require domestic advisers to count each U.S. and non-U.S. investor of a private fund for purposes of the private adviser exemption. Generally, this means that an adviser must count each shareholder of a corporate fund, each limited partner of a partnership, each member of a limited liability company, and each beneficiary of a trust. Further, an adviser that advises individual clients directly will have to count those clients together with the investors in those private funds that it advises in determining its total number of clients. An adviser, however, is not required to count itself or certain of its knowledgeable advisory personnel who are “qualified clients” (*i.e.*, who are “insiders”) as clients. Advisers should note that they may not circumvent the New Rules by making a private fund investor a partner in their advisory firm to avoid counting the investor for purposes of the private adviser exemption.

Fund of Funds. Advisers will be required to look through “fund of funds” investors in counting their clients for purposes of the private adviser exemption. A “fund of funds” is defined under the New Rules as “any limited partnership (or limited liability company or other type of pooled investment vehicle) that invests at least 10 percent of its total assets in other pooled investment vehicles that are not related persons of the fund of funds, or related persons of the adviser or general partner of the fund of funds.”

Offshore Advisers. The New Rules require advisers with principal offices and places of business outside the United States (“offshore advisers”) to look through the private funds they manage, regardless of whether those funds are also located offshore, and count those investors that are U.S. residents as clients. An offshore adviser that has more than 14 advisory clients (meaning U.S. investors in the adviser’s private fund and other advisory clients) that are U.S. residents in the preceding 12 months will generally have to register under the Act. Determination as to an investor’s residence may be made at the time the investor makes an investment in the private fund. If an investor is a non-U.S. client at the time of making the initial investment in the private fund, the offshore adviser may continue to count the investor as a non-U.S. client even if the investor later relocates to the United States. Alternatively, if a non-U.S. investor transfers his interest to a U.S. investor, the offshore adviser should count the transferee as a U.S. client. For purposes of determining whether an investor is a U.S. client or a non-U.S. client, the SEC has stated that it would not object if offshore advisers used the following analysis in determining the residence of an investor: (i) in the case of individuals to their residence, (ii) in the case of corporations and other business entities to their principal office and place of business, (iii) in the case of personal trusts and estates to the rules set out in Regulation S of the Securities Act of 1933, as amended (the “Securities Act”), and (iv) in the case of discretionary or non-discretionary accounts managed by another investment adviser to the location of the person for whose benefit the account is held.

Registration with the SEC: Assets Under Management

Under the Act, an adviser with more than 14 clients whose principal office and place of business is in the United States cannot (subject to certain exemptions) register with the SEC unless it manages at least \$25 million. If an adviser manages less than \$25 million, the adviser must comply with the investment adviser statutes of the state where its principal office and place of business is located. Offshore advisers, however, with more than 14 clients who are resident in the United States must register with the SEC, regardless of the amount of assets the adviser has under management. In determining the amount of assets it has under management, an adviser must include the total value of its securities portfolios (including leverage) in its assets under management. An adviser, however, may exclude proprietary assets invested in the fund, which include investments of certain insiders and their families.

Offshore Advisers to Offshore Privately Offered Funds

The New Rules provide that offshore advisers of offshore private funds may treat the funds as single non-U.S. clients for most purposes under the Act even though the fund have U.S. investors. Because the SEC generally does not apply most of the substantive provisions of the Act to non-U.S. clients of offshore advisers, the substantive provisions of the Act generally would not apply to an offshore adviser's dealings with an offshore fund. This means that those requirements set forth in the Act's compliance rule, custody rule, and proxy voting rule will generally not be applicable to offshore advisers of offshore private funds. Offshore advisers required to register under the Act, however, will remain subject to the Act's antifraud provisions, will need to keep certain books and records as mandated by the SEC rules and will be subject to examinations by the SEC staff.. The SEC is not prohibiting offshore advisers from representing themselves as SEC-registered advisers, despite not having to comply with many provisions of the Act, although substantial clarification and disclosure may be necessary to make such a representation not misleading.

Recordkeeping

In general, Rule 204-2 of the Act requires advisers to maintain certain books and records. The books and records required to be kept include copies of performance records necessary to form the basis of any performance advertisements for a period of 5 years after the performance information is last used. Because newly registered advisers may be placed at a competitive disadvantage as a result of not being able to use certain performance data, the SEC has adopted an amendment to Rule 204-2 to permit newly registered advisers to market their performance from periods prior to their registration with the SEC, even if they have not kept documentation that the SEC rules would otherwise require. Advisers are, however, required to retain whatever records they do have that support the performance history prior to their registration with the SEC. Once an adviser has registered with the SEC, it will have to comply with the recordkeeping rule going forward.

Further, the SEC recognizes that it is common for advisers to establish special purpose vehicles for purposes of operating certain private funds. In order to determine whether an adviser is meeting its fiduciary obligations with respect to those private funds in which it has created a special purpose vehicle, the SEC has also amended the recordkeeping rule to clarify that, for purposes of Section 204 of the Act, "the books and records of a registered adviser include records of the private funds for which the adviser acts as investment adviser and the adviser or a related person acts as general partner, managing member, or in a similar capacity."

Performance Fees

The Act imposes restrictions on an adviser's ability to charge performance fees to its clients. In general, an adviser is permitted to charge a performance fee to clients that are deemed to be "qualified clients," meaning investors that have at least \$750,000 under

management with the adviser or have a minimum net worth of \$1,500,000. In order not to disrupt existing compensation arrangements between an adviser and its clients, the SEC has added grandfathering provisions to Rule 205-3. Accordingly, existing owners in any private fund exempted pursuant to Section 3(c)(1) of the Investment Company Act may “retain their investment in a private fund and add to it, and to permit newly-registered advisers to continue in effect advisory contracts they may have with other clients that are not Section 3(c)(1) funds.” The New Rules, however, effectively raise the eligibility standards of new investors in private funds.

Custody

An adviser who has custody or possession of any client funds or securities (including the ability to deduct fees from an account) must comply with certain asset “safekeeping” requirements in Rule 206(4)-2 of the Act. Under with Rule 206(4)-2, advisers to private funds generally must engage qualified custodians to hold fund assets and provide audited annual financial statements of the private fund to investors within 120 days of the end of the fund’s fiscal year. Rule 206(4)-2 has been amended to allow additional time for completion of audit work by extending the 120 day time period to 180 days.

Form ADV

The SEC registration form for advisers, Form ADV, is comprised of two parts: Part I and Part II. Currently, Part I of Form ADV is filed electronically through the Investment Adviser Registration Depository and is publicly available over the Internet. Part II of Form ADV, which is given to prospective clients, is completed in paper and is not filed with the SEC (although the SEC has proposed to require it to be filed electronically). Form ADV requires disclosure of, among other things, (1) the ownership of the adviser, (2) the disciplinary history of the adviser, certain affiliates of the adviser, and the adviser’s officers, directors and employees; and (3) the adviser’s management and trading practices, including any conflicts of interest. Form ADV has been amended under the New Rules to now identify advisers to private funds. There has been some concern that the identification of private funds in Form ADV may raise general solicitation questions under the Securities Act. The SEC, however, has stated that the mere identification of a private fund in Form ADV will not render Section 4(2) of the Securities Act or Rule 506 thereunder unavailable.

Other Amendments

Rule 203(b)(3)-1 of the Act provides for certain types of entities and persons to be deemed a single client for purposes of the Act. Rule 203(b)(3)-1 has now been amended to clarify that advisers may not count private funds as single clients. Both Rules 222-2 and 203A-3 have also been amended to clarify that advisers and supervised persons may, for purposes of those rules, count clients as provided in Rule 203(b)(3)-1 without giving regard to the look through requirements in Rule 203(b)(3)-2.

About the Morgan Lewis Private Fund Services Group

With over 1,200 lawyers in 19 offices, Morgan Lewis is among the 10 largest law firms in the United States. Our Private Fund Services Practice Group provides a full range of legal services to clients in the financial services industry in the United States and abroad. Our clients include investment companies, investment advisers, broker-dealers, venture capital and hedge funds (both domestic and offshore), banks and trust companies, insurance companies, pension plans and consultants, transfer agents and other industry participants. Our interdisciplinary approach to counseling clients combines the knowledge of lawyers familiar with the federal and state securities laws, the Employee Retirement Income Security Act of 1974 (ERISA), the Internal Revenue Code, commodities regulation, federal and state banking and insurance laws, and foreign securities laws.

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