



GlobalNote

SEC Response to ABA Letter Regarding Hedge Fund Adviser Registration Rules and Other Hedge Fund Adviser Rules¹

Summary

On December 8, 2005, the Division of Investment Management (the “Division”) of the Securities and Exchange Commission (the “SEC”) responded to a letter dated June 23, 2005 (the “ABA Letter”) from the ABA Subcommittee on Private Investment Entities (the “ABA”). In the ABA Letter, the ABA requested clarification on various interpretive issues regarding the new rule (the “Rule”) requiring certain hedge fund advisers to register under the Investment Advisers Act of 1940 (the “Advisers Act”).² The ABA also requested clarification on various other issues arising under the Advisers Act. This memorandum summarizes the response of the Division. Note that the Division emphasizes that their response to the ABA Letter is not a rule, regulation, or statement of the SEC, and solely expresses the Division’s views.

Background

The Rule, generally effective on February 10, 2005 and requiring certain hedge fund advisers to register by February 1, 2006, requires hedge fund advisers to “look through” certain hedge funds that they advise, for client counting purposes, so that each investor counts as a client (vs. each fund). An adviser is exempt from registration if it has had fewer than fifteen clients during the preceding twelve months. Note that individual clients of the investment adviser are also counted towards the fifteen-client threshold.

¹ 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.thshlaw.com.

² See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) (the “Adopting Release”).

The counting requirements of the Rule apply only to investors in a “private fund”—defined in rule 203(b)(3)-1 as a fund (i) that would be subject to regulation under the Investment Company Act of 1940 but for the 3(c)(1) and 3(c)(7) exemptions under such act, (ii) that permits investors to redeem their interests within two years of purchasing them, and (iii) in which the interests are offered based on the investment advisory skills, ability or expertise of the investment adviser. The intent of the SEC in formulating the definition of a “private fund” was to reference three characteristics shared by hedge funds, that differentiate hedge funds from private equity funds and venture capital funds.

Definition of a Private Fund

Redemption

The Division clarifies that the soonest an investor can redeem without triggering the redemption component of the “private fund” definition is two years after the investment date. Therefore, if the investor purchases an interest on January 1, 2007 and redeems on December 31, 2008, the fund is a “private fund” for purposes of the Rule. But if that same investor redeems on January 1, 2009, the fund is not a “private fund” for purposes of the Rule.

Advisers, general partners and knowledgeable employees are not permitted to redeem their ownership interests within two years of purchase without causing the fund to be a “private fund.” However, the Division would not recommend enforcement action to the SEC against an adviser that fails to register solely because it did not treat the adviser’s or its affiliated general partner’s withdrawal of the incentive fee or incentive allocation within two years as a redemption, as such fee or allocation is not a contribution of capital, but rather compensation for services provided.

The ABA requested clarification regarding whether a transfer by an investor from one class of a fund to another class in the same fund (e.g., if the investor’s legal status or residence changed) would constitute a redemption where the two fund classes have “substantially similar investment objectives, risk portfolio compositions, risk/return characteristics and liquidity.” The Division responds that such a transfer may constitute a redemption depending on the particular facts. However, such a transfer would not constitute a redemption if the two classes had the same underlying portfolio of securities (in the same proportion) and provided investors with the same redemption rights. The same reasoning would apply to a transfer between feeder funds that invest all of their assets in the same master fund. With respect to any transfer that does not constitute a redemption for purposes of the definition of “private fund” under the Rule, the two-year holding period would run from the date of purchase of the interest in the original class.

Extraordinary Events

The Rule provides that a fund may permit redemption within two years of purchase in the case of certain extraordinary events without triggering the “private fund”

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definition. The ABA argues in the ABA Letter that dissolution or liquidation of an entity investor is analogous to death or disability of a natural person investor (each of which is an extraordinary event for purposes of the Rule). The Division agrees that dissolution or liquidation of an entity investor may be considered an extraordinary event, as long as the adviser has a reasonable basis to believe that the entity investor's dissolution or liquidation is bona fide and not designed to avoid the two-year redemption requirement. The adviser must make reasonable inquiry as required by the Rule. Bankruptcy of an investor, whether an individual or an entity, is also an extraordinary event.

The death or incapacity of key personnel of the adviser is an extraordinary event. However, a significant withdrawal of proprietary investments by the adviser or its personnel is not, since such withdrawal is within the adviser's discretion. In fact, if the investors have negotiated for redemption rights in the event of such a withdrawal, the fund would meet the definition of a "private fund" and the adviser would be required to register with the SEC. (But note that this aspect of the Rule applies only to investments made on or after February 1, 2006, since the two-year redemption test applies only to investments made on or after February 1, 2006.)

Appreciation / Income

The Division agrees with the ABA that appreciation and income associated with an investment may be redeemed at the same time as the original investment for purposes of the two-year redemption test (as opposed to the investor being required to wait until two years after the appreciation or income is earned).

Transfers of Interests

An investor's transfer of an interest in a fund to a second investor in secondary market transaction will not be considered a redemption for purposes of the definition of "private fund" and the original purchase date may be attributed to the transferee (including if the transfer is a gift), as long as there was no arrangement between the fund and either investor to circumvent the two-year holding period requirement.

Subadvisers; Offshore Advisers

The ABA suggests in the ABA Letter that certain subadvisers be exempted from the registration requirements of the Rule, because the subadvisers are not managing the hedge fund, but merely providing their specialized skills to the registered adviser (e.g., if the subadviser manages 15 percent or less of the fund's assets at the time it is hired and is not named in the offering memorandum for the fund).

The Division, citing footnote 243 of the Adopting Release, re-affirms that all of a hedge fund's advisers, including its subadvisers, are required to look through a private fund for purposes of the counting component of the Rule. The Division believes that the same policy considerations applicable to the primary adviser of a hedge fund apply to the fund's subadvisers. "In our view, a subadviser that manages a portion of the private

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fund's assets, with or without investment discretion, is managing the fund and is not merely providing its specialized skills to the fund's primary adviser."

However, the Division states that it appreciates that different policy considerations apply to subadvisers located offshore (determined by reference to the subadviser's principal office and place of business). An offshore subadviser may have "particular access to non-U.S. markets" and may decline to manage a fund's assets if required to register; and the Division does not want to limit U.S. investors' access to offshore investment opportunities. Therefore, the Division would not recommend enforcement action to the SEC against an offshore subadviser that advises a "private fund" and does not register, as long as the following five conditions are met: (i) the subadviser is hired (and may be discharged) by the fund's primary adviser (note that "primary adviser" is defined by the Division as the adviser that is registered); (ii) the subadviser is not otherwise required to register as an investment adviser with the SEC; (iii) the adviser and the subadviser are not affiliated; (iv) the written materials distributed to investors in the fund disclose that a portion of the fund's assets maybe be managed by an offshore subadviser that is not registered; (v) the unregistered offshore subadviser does not manage more than 10 percent of the fund's total assets, measured at the time such subadviser is hired and at the time any additional assets of the fund are allocated to the subadviser for management.

The Division notes that if the registered primary adviser has custody of the fund's assets, delegation of management of those assets to the unregistered subadviser does not divest it of custody under rule 206(4)-2.

Separate Redemption Provisions

If a fund uses side letters to provide some, but not all, investors the opportunity to redeem shares within two years, the fund meets the definition of a "private fund." Accordingly, if an offshore fund permits non-U.S. investors to redeem their interests within two years while restricting the U.S. investors, the fund meets the definition of a "private fund."

Issues Under the Rule (Other than Definition of a Private Fund)

Registration of Affiliates

If a registered investment adviser to a private fund establishes an entity to act as the fund's general partner or managing member, and if such entity has no employees or other persons acting on its behalf other than the officers, directors, partners or employees of the adviser, such entity may remain unregistered as long as certain conditions are met. In essence, registration would not be necessary as long as the general partner or managing member (and its employees or other persons acting on its behalf) were subject to the registered adviser's supervision and control and therefore constituted "persons associated with" the registered investment adviser. In that case, the SEC could enforce the requirements of the Advisers Act against both the registered investment adviser and

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the affiliated general partner or managing member (and its employees or other persons acting on its behalf).

Foreign affiliates of a registered investment adviser—e.g., a foreign affiliate with at least one portfolio manager, established to take advantage of investment opportunities in the relevant non-U.S. jurisdiction—are not required to register if the facts and circumstances are substantially similar to those described in certain SEC no-action letters (the “Letters”). Again, the argument for the Division not recommending enforcement action in these cases is that the advisory activities of such foreign affiliates (referred to as “participating affiliates” in the Letters) would be subject to the Advisers Act and the SEC’s regulatory oversight.

Please note that, in light of the fact-specific nature of this issue, it is important to seek the advice of counsel with respect to any particular case. Furthermore, the Division states in its response to the ABA Letter: “We encourage registered advisers and participating affiliates that wish to rely on the Letters to contact the staff if they have questions in light of recent changes to the rules.”

Family Offices and Family Funds

Family investment funds are not excluded from the definition of “private fund” on the basis that the adviser is a family member or an entity controlled by family members, or because the fund is offered only to family members. Like all funds, such funds fall within the definition of “private fund” unless the interests in the fund are not offered based on the investment advisory skills, ability or expertise of the investment adviser. The Division recognizes that some family investment funds may not be offered based on the expertise of the adviser, and states in its response to the ABA Letter that “[w]hether a fund is offered based on its adviser’s expertise is determined by the facts and circumstances of that particular fund.”

For purposes of counting the adviser’s clients under the Rule, all investors, including family members, must be counted as clients.

Related Issues

The Division provides its views on various issues arising under the Advisers Act that the ABA suggests are unique to hedge fund managers.

Trading Issues—Principal Transactions and Rebalancing

The Division responds to the ABA’s concern that certain rebalancing transactions between multiple funds advised by an investment adviser, all with the same investment strategy, could be viewed as principal transactions subject to section 206(3) of the Advisers Act if one or more of the funds contains proprietary assets of the adviser and its personnel. (The adviser would effect “cross transactions”—i.e., sell securities from one fund and purchase the same securities for another fund in a simultaneous transaction—for

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the purpose of rebalancing the funds on a regular basis, to reflect contributions and redemptions that are disproportionate among the funds, so that each fund maintains the same pro rata ownership of each securities position.) The Division states that whether section 206(3) of the Advisers Act applies to such transactions “depends upon all of the facts and circumstances.”

The Division also notes that sections 206(1) and (2) of the Advisers Act may apply regardless of whether section 206(3) also applies, and may require prior disclosure of the rebalancing transactions.

Form ADV

The Division indicates that Section 7.B of Schedule D requires a registered adviser to report both the feeder funds and the master fund in a “master-feeder fund” structure, even if the only investors in the master fund are the feeder funds, and to identify the current value of the total assets in each fund.

The Custody Rule

After briefly summarizing Rule 206(4)-2 under the Advisers Act (the “Custody Rule”), the Division answers three ABA questions regarding the Custody Rule.

The Use of Offshore Prime Brokers. The Division confirms that a qualified custodian under the Custody Rule may include “a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients’ assets in customer accounts segregated from its proprietary assets,” as provided in the Custody Rule. Also in accordance with the Custody Rule, the foreign financial institution or offshore prime broker that is acting as the qualified custodian must either maintain a separate account for each advisory client under the client’s name or maintain a separate account for the assets of the adviser’s clients under the adviser’s name as agent or trustee for the clients.

Definition of Privately Offered Securities. The Division declines to expand the definition of “privately offered securities” in accordance with the interpretation sought by the ABA in the ABA Letter. “Privately offered securities” are securities that are not publicly offered, are uncertificated, and are transferable only with the prior consent of the issuer or holders of the outstanding securities of the issuer. The ABA sought to expand the definition to include securities that have a different impediment to transferability (“payment or transfer of a security is controlled by, or requires approval from, a third party”), such as certain loans, privately negotiated derivatives and other instruments that the ABA believes should not be required to be maintained with a qualified custodian.

Amortization of a Fund’s Start-Up Costs. The Division states: “In adopting the 2003 amendments to the Custody Rule, the Commission clearly indicated that the exception to the quarterly reporting requirement is available only to advisers to pooled investment vehicles whose financial statements are fully GAAP compliant.” The

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exception to the quarterly reporting requirement permits registered advisers to distribute audited financial statements prepared in accordance with generally accepted accounting principles (“GAAP”) within 120 days of the end of the fiscal year (or 180 days in the case of a fund of funds), instead of quarterly account statements (generally distributed by the qualified custodian). However, many funds amortize start-up costs, which is not in accordance GAAP. If a fund amortizes start-up costs, its registered adviser (or qualified custodian) must distribute quarterly account statements.

Record Retention

A third-party administrator (the “Administrator”) of a registered investment adviser may maintain the books and records required to be kept under rule 204-2 under the Advisers Act, although paragraph (e) of such rule requires that the adviser keep the records in an appropriate office of the adviser, as long as (i) the Administrator acts as a service provider to the adviser in maintaining, preparing, organizing and/or updating the records for the adviser’s ongoing use in its business (vs. merely providing storage) and (ii) upon request of the SEC staff, the records are produced promptly for the staff at the appropriate office of the adviser or an office of the Administrator.

The Division states that Rule 204-2(l) does not cause the books and records of a private fund to be records of the adviser if neither the adviser nor any of its related persons acts as the fund’s general partner, managing member, or in a similar capacity. Accordingly, where a majority of the directors of an offshore private fund formed as a corporation are not affiliated with the adviser, the books and records of the fund will not be considered records of the adviser for purposes of section 204 of the Advisers Act.

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If you have any questions or comments regarding the SEC response to the ABA Letter, please feel free to contact:

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