



SEC INVESTMENT ADVISER REGISTRATION FOR HEDGE FUND MANAGERS – THE PRIVATE FUND RULE

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I. Overview and Regulatory Setting. ²

The US Investment Advisers Act of 1940, as amended, (“Advisers Act”) requires an investment adviser to register as such with the United States Securities Exchange Commission (“SEC”) if during the course of the preceding 12 months it has had 15 or more clients and has assets under management of US\$30 million or more.³ (Note that the asset test does not apply to non-US investment advisers, only to US based advisers.⁴)

The asset test is objective, while the number of clients test is not as clear. For that reason, the issue *du jour* is the method by which the number of clients is counted for purposes of determining the need to register. As to funds and collective investment schemes and whether or not each can be treated as a single client, there are a myriad of rules, chief among them the new notion of a “private fund”⁵ which dictates at what point

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² On December 2, 2004, the U. S. Securities and Exchange Commission (“SEC”) released final rules requiring certain hedge fund managers to register as investment advisers under the Investment Advisers Act of 1940, as amended (“Advisers Act”). See also Securities and Exchange Release No. IA-2333 (December 2, 2004) (“Release No. IA-2333”); Registration Under the Advisers Act of Certain Hedge Fund Advisers; proposed rule. 69 Fed. Reg. 45172 (July 28, 2004) (unless otherwise indicated, all page references to Release No. IA-2333 are references to Release No. IA-233 as found on the SEC’s website at sec.gov). 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 set forth in the amended Rule 205-3(c)(2)) and the rules regulating performance advertisement set forth in amended Rule 204-2(e)(3)(ii) to accommodate previously non-registered hedge fund managers that must now register with the SEC. Lastly, the SEC’s response to the American Bar Association Business Section Committee submission is informative as well (“ABA Letter.”) SEC Response to the American Bar Association Business Law Section submission, 2005 WL 3334980 (SEC No-Action Letter), dated December 8, 2005, referred to herein as the “ABA Letter.”

³ Sec. 203A(a)(1)(A). There may be other circumstances that mandate registration, as for example, would be the case with an investment adviser to a registered investment company (a mutual fund, under the Investment Company Act of 1940.) Note also that the statute references \$25 million because it is worded as exemption from registration. If the adviser has less than \$25 million it need not register. The SEC rules indicate that going over \$30 million requires registration. The gap can be thought as a sort buffer zone given the fluctuation of asset values. For better understanding however note that the two numbers – 25 and 30 - are drawn from the same registration concept, one to be used in avoiding registration and one to be used in determining is registration is mandatory.

⁴ Release No. IA-2333, at 20.

⁵ Rule 203(b)(3)-1(d) and 203(b)(3)-2

one is required to look through the entity (i.e. the private fund) and treat each investor as a client. That issue is the primary focus of the new rules that went into effect February 1, 2006 and as such is the focus of this article.

The statutory rule contains defined terms that are important to grasp for a better understanding of this article:

a. The term “**investment adviser**” is defined, inter alia, as a person who for compensation engages in the business of advising others either directly or through publications or writings as to the value of securities or as to the advisability of investing in, purchasing, or selling securities or who for compensation and as part of a regular business issues or promulgates analyses or reports concerning securities (and then there follows in the statute a list of exceptions – banks and the like.)⁶

b. The term “**assets under management**” means the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services.⁷ Again, the assets under management test is inapplicable to non-US advisers.⁸ The adviser may consider its own assets if it wishes (i.e. in order to be permitted to register.)⁹ For purposes of (only) determining the amount of assets under management, only US assets are taken into account.¹⁰

c. The term “**client**” is not defined in the statute but is defined in Rule 203(b)(3)-1. The precise statutory language should be consulted in each case,¹¹ but in general, natural persons, relatives within the same household and certain trusts for such persons are all treated as a single client. As stated above, whether or not each fund can be treated as a single client, and how the definition of “private fund”¹² impacts the analysis, is detailed below.¹³

As to effective dates, non-registered hedge fund advisers that are required to register with the SEC under new Rule 203(b)(3)-2 must have done so by February 1,

⁶ Sec. 202(a)(11)

⁷ Sec. 203A(a)(2)

⁸ Release No. IA-2333, at 20.

⁹ *Id.*

¹⁰ *Id.*

¹¹ See Appendix 1 for the statutory definition as effective February 1, 2006.

¹² Rule 203(b)(3)-1(d) and 203(b)(3)-2

¹³ Until the adoption of Rule 203(b)(3)-2, hedge fund managers had been able to rely on the exemption from investment adviser registration by virtue of Sec. 203(b)(3) and former Rule 203(b)(3)-. The prevailing rule at that time had been that the fund itself and not each underlying beneficial owner of such a fund would be the “client.” Accordingly, as long as the hedge fund manager provided investment advisory services to fourteen or less funds (or funds and managed accounts in total) such manager would have been exempt from registration under the Act.¹³ As the text indicates, the change that has come into law effective February 1, 2006, is the method by which the number of clients is to be counted.

2006, must have filed Part I of Form ADV with the SEC, have prepared Part II of Form ADV, adopted the various compliance policies and procedures required under the Advisers Act, and appointed a chief compliance officer.¹⁴

Accordingly, this paper addresses the following topics:

- 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 rules and most significantly how the private fund definition impacts the counting of the number of clients of an investment adviser so as to require registration under the Advisers Act.
- The application of Rule 203(b)(3)-2 with respect to non-US based hedge fund managers and sub advisers who render advice to registered or non-registered advisers of private funds.
- 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 books and records.)¹⁵

II. Who Must Register?

For US Fund managers, Rule 203(b)(3)-2 now controls and introduces three questions to be asked to determine if a US based manager needs to register:¹⁶

- Does the hedge fund manager operate a “private fund”?;
- Does the hedge fund manager have fifteen or more clients (i.e., investors)?; and
- Does the amount of assets under management exceed \$25 million/\$30 million from US sources?¹⁷

¹⁴ A separate memorandum prepared by Tannenbaum Helpern Syracuse & Hirschtritt LLP providing an overview of the compliance requirements imposed by the Advisers Act and other statutes entitled “Compliance and Filing Requirements for Fund Managers that Are Registered Investment Advisers” (December 2004) is readily available. There is a more comprehensive discussion on compliance and the written compliance program needed in a separate memorandum prepared by the law firm entitled “SEC Adopts Final Rules Requiring Registered Investment Advisers to Implement Written Compliance Program” (January 7, 2004). See the law firm’s website at www.thshlaw.com to obtain a copy of either or both.

¹⁵ *Id.*

¹⁶ The safe harbor from registration as an investment adviser is not available with respect to private funds. See Preliminary Note to Sec. 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.

¹⁷ Release No. IA-2333, at 20.

If the adviser is non-US based, then only US investors are considered and the dollar test is inapplicable.

A. The Starting Point: Does the Hedge Fund Manager Operate a “Private Fund?”

The SEC Staff has adopted the new term “private fund” to determine whether an investment adviser of a pooled investment vehicle (or fund) would have to register as an investment adviser. A “private fund” is a pooled arrangement:

- that would be an “investment company” under Sec. 3(a) of the Company Act but for the exception provided from that definition by either Sec. 3(c)(1) or Sec. 3(c)(7) of such Act;
- that permits owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and
- that offers interests which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.¹⁸

A pooled investment vehicle that does not satisfy any one of the three elements is not a “private fund.” The effect of not being a private fund is that the pooled investment vehicle may be counted as a single client when making the 15 client count. If the pooled investment vehicle is a private fund, then each investor is counted.

1. Sec. 3(c)(1) and 3(c)(7) of the Company 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 Sec. 3(c)(1) or 3(c)(7) of the Company Act.¹⁹ Sec. 3(c)(1) excepts from the definition of “investment company” an issuer that is beneficially owned by not more than 100 persons and is privately placing its securities. Sec. 3(c)(7) excepts from the definition of “investment company” an issuer that is owned exclusively by “Qualified Purchasers” as defined in Sec. 2(a)(51)(A) of the Company Act and that is privately placing its securities.²⁰ Virtually all hedge funds satisfy one of these two exceptions so it can generally be assumed that the answer to this question will be in the affirmative.

2. Redemption within Two Years

¹⁸ See Sec. 203(b)(3)-1(d) of the Advisers Act.

¹⁹ Release No. IA-2333, at 23, note 226.

²⁰ The Company Act and SEC rules define a “qualified purchaser” as a natural person who possesses at least \$5 million in investments; a non-natural person that possesses at least \$25 million in investments or is owned exclusively by qualified purchasers; and a qualified institutional buyer. See 15 U.S.C. 80a-2(a)(51); 17 CFR 270.2a51-1 to 270.2a51-3.

A pooled investment vehicle is a “private fund” if it permits investors to redeem their interests in the fund within two years of investment.²¹ The two-year lock up concept applies to each interest purchased or amount of capital contributed to the pooled investment vehicle after the February 1, 2006 effective date.²² It is clear that the lock up must be for more than a full two-year period.²³ The ABA Letter clarifies this: If an investor purchases an interest on January 1, 2007 and can redeem on December 31, 2008, the investment is considered liquid and the fund is a “private fund.” But if that same investor cannot redeem until January 1, 2009, a day later, the fund is not a “private fund” for purposes of the Rule.

Note that the lock up rule applies to capital invested on or after February 1, 2006; investments before that date are grandfathered.

The SEC adopted the two-year lock-up element because it believed 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 funds and venture capital funds, and therefore the SEC believed that advisers to such funds should not be the focus of its examination staff resources.²⁴

a. Compensation Arrangements. Several issues are raised as a result of the redemption rule, one being the effect on common compensation arrangements. Often, compensation arrangements entail an incentive credit or allocation to the capital account of the general partner or adviser. The Staff has indicated that it would not recommend enforcement action 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. In other words, such allocation would not be a contribution of capital, but rather compensation for services provided, and the redemption rule does not apply to it.

b. Transfers. Another issue raised relates to transfers. There are at least two types of transfers: An investor transferring from one interest or form of investment to another within the context of the same asset pool, and the transfer by an investor to a second investor in a secondary market transaction, or by gift, or on death.

²¹ The SEC Staff found that “hedge funds generally offer semi-annual, quarterly, or monthly liquidity terms to their investors.” Release No. IA-2333, at 23-24, 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 redemption feature promotes the purposes of the Advisers Act by applying the rule to those relationships to which the Advisers Act was designed to address. Release No. IA-2333, at 24, note 237.

²² 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 23, note 231.

²³ See ABA Letter, I.A. Issue 1. The Staff interprets the two-year requirement as two years and a day.

²⁴ Release No. IA-2333, at 23-24.

(i) **Investor's Transfer.** 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 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.²⁵ The same reasoning would apply to a transfer between feeder funds that invest all of their assets in the same master fund. This means that the two-year holding period runs from the date of original purchase and tacks onto the holding period of the second class or the second feeder. However, according to the ABA Letter, a transfer may in fact constitute a redemption where the two fund classes have only "substantially similar investment objectives, risk portfolio compositions, risk/return characteristics and liquidity."²⁶ "Substantially similar" may not be enough; rather it appears that the underlying assets need to be *identical*.

(ii) **Investor to Investor.** 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.

c. Extraordinary Events. A fund may permit redemption within two years of purchase in the case of certain extraordinary events without triggering the "private fund" definition.

(i) **Dissolution, etc.** 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 holding period requirement. Bankruptcy of an investor, whether an individual or an entity, is also an extraordinary event. In any event, the adviser must make reasonable inquiry as required by the Rule.

(ii) **Death of Principal.** But what of the death or incapacity of key personnel of the adviser? Is that an extraordinary event? The answer is yes. According to the SEC Staff, a fund may permit redemptions within two years of purchase without triggering the "private fund" definition in the event of the death or incapacity of key personnel at the adviser.²⁷ This is an important issue because often investors negotiate a right to withdraw

²⁵ Two funds or two classes that are the same but for a different side pocket investment would not pass muster and such a transfer would be a redemption and reinvestment.

²⁶ See ABA Letter, at 4, Answer 4. "Where the classes have only "substantially similar" investment objectives...the transaction may involve a redemption under rule 203(b)(3)-1(d)."

²⁷ See ABA Letter, at 6, Answer 2.

when such an event occurs and such would be considered an extraordinary event.

(iii) **Significant Withdrawals.** However, a significant withdrawal of proprietary investments by the adviser or its personnel is not an extraordinary event, because 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.²⁸

(iv) **Others.** Furthermore, the SEC Staff has taken the position that offering redemption rights that permit an investor to redeem part or 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.²⁹

d. Capital Appreciation. Capital 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 each tranche of appreciation or income is earned.)

e. Side letters. Note that an adviser 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, would run afoul of the Rule. The fund cannot use side letters as a means to bypass the two-year redemption test.³⁰ According to the SEC Staff, a pooled investment vehicle that uses side letters to provide any investors the opportunity to redeem shares within two years would meet the definition of a "private fund."³¹

f. Insiders as Owners. The redemption rule applies to all owners of the fund, raising the issue of the status of insiders to the investment manager. According to the ABA Letter, the two-year redemption rule applies to the advisory firm itself and its employees, including "knowledgeable employees" – they too are owners for this purpose. There is no exclusion for insiders.³² However, where an employee of the advisory firm invests in the fund and later resigns and redeems its interests in the fund, such redemption

²⁸ *Id.*

²⁹ Release No. IA-2333, at 23-24, note 240.

³⁰ Release No. IA-2333, at 24, note 233.

³¹ Release No. IA-2333, at 24, note 233.

³² ABA Letter Answer 2.

will be considered an extraordinary event for the purposes of the two-year redemption rule. Thus, in this case, the redemption will not cause the fund to be considered a “private fund.”

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.³³ According to the SEC Staff, in the Adopting Release, 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.³⁴ Investors not only expect to receive but are solicited explicitly on the basis of the investment management ability of the hedge fund manager.³⁵ As such, the SEC Staff adopted this element to confirm the direct link between the fund adviser’s management services and the investors’ decision to invest in such adviser’s fund.³⁶

The initial comments led many to believe that the test would be met only if the identity of the manager had been disclosed in the offering materials such that the reliance could be shown. The ABA Letter makes it clear that the offering materials need not disclose the identity of the manager to meet this requirement.³⁷ The effect of such a position is that any manager that manages a portion of the fund’s assets meets this test. This is particularly relevant in the case of funds of funds, of course, and in the case of subadvisers.

a. Subadvisers. Generally, the ABA had suggested that certain subadvisers be exempted from the registration requirements of the Rule because the subadvisers are not managing the hedge fund, per se, but rather providing their specialized skills to the investment adviser.³⁸ The SEC Staff, however, citing footnote 243 of the Adopting Release, re-affirmed 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.³⁹ The SEC Staff wrote: “In our view, a subadviser that manages a portion of the private 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.”⁴⁰ Accordingly, US based subadvisers, at least, are treated precisely the same as primary advisers.

³³ Release No. IA-2333, at 24.

³⁴ Release No. IA-2333, at 24.

³⁵ Release No. IA-2333, at 18.

³⁶ Release No. IA-2333, at 18.

³⁷ ABA Letter, at 28, Answer 2.

³⁸ ABA Letter, at 7 and 27.

³⁹ Release No. IA-2333, at 24, note 243.

⁴⁰ *Id.*

b. Non-US Subadvisers. Purely as a result of policy considerations, subadvisers located outside of the US (determined by reference to the subadviser's principal office and place of business) are treated differently. There are real reasons for a primary adviser to retain the services of a non-US subadviser, for example, to assist in certain markets where the special contacts and expertise of the subadviser are all important. A non-US subadviser may have "particular access to non-US markets" and may decline to manage a fund's assets if required to register. The SEC Staff did not want to limit US investors' access to offshore investment opportunities. Therefore, the SEC Staff indicated that it would not recommend enforcement 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;
- (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 a non-US based subadviser that is not registered with the SEC; and
- (v) the unregistered non-US 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 (and presumably subtracted from) the subadviser for management.

The SEC Staff 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. Moreover, the primary adviser is given responsibility for the books and records and other compliance features.⁴¹

c. 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 SEC Staff recognizes that some family investment funds may not be offered based on the expertise of the adviser, and states in 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."

⁴¹ ABA Letter, at 28, Answer 1.

B. The Second Test: Counting Clients in a Private Fund

Generally, if the pooled investment vehicle meets the definition of “private fund,” then the adviser must “look through” the “private fund” to determine the number of clients. In general, an adviser must count as clients the shareholders, limited partners, members or beneficiaries of a “private fund.”⁴²

Note that the adviser is to count investors in the aggregate when determining if it 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.⁴³ And, of course, if the adviser manages separate accounts as well, each managed account counts towards the 15 client threshold.⁴⁴

Lastly, a US adviser counts both US investors and non-US investors towards the 15 client threshold.⁴⁵ A non-US adviser counts only US investors.⁴⁶

1. Certain Other Look Through Rules.

a. Persons Included in the 15 Count. A non-US adviser looks through the following investors in making the 15 count:

- (i) A master fund if the master fund has a feeder fund that (i) satisfies the definition of “private fund” and (ii) has US investors.⁴⁷ In such a situation, the adviser is to count the total number of US investors in the master-feeder complex;
- (ii) Insurance companies;
- (iii) Broker dealers; and
- (iv) Banks.⁴⁸

Additionally, an adviser would not look through a non-US domiciled pooled investment vehicle if the interests in such offshore fund are offered only to non-US investors. In such a case, the fund would not be relying on Sec. 3(c)(1) or 3(c)(7) of the

⁴² Rule 203(b)(3)-2(a) under the Advisers Act.

⁴³ Release No. IA-2333, at 20, note 186.

⁴⁴ “[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 Sec. 203(b)(3).” See Release No. IA-2333, at 20.

⁴⁵ Rule 203(b)(3)-1(b)(5) under the Advisers Act.

⁴⁶ Release No. IA-2333, at 22, note 201.

⁴⁷ Release No. IA-2333, at 23, note 227.

⁴⁸ Release No. IA-2333, at 23.

Company Act and therefore, such investment vehicle would not be a “private fund.” Such a fund would be treated as one client.

Note, that if an individual invests in two “private funds” advised by the same hedge fund manager, that individual is counted only once toward the 15 client threshold.⁴⁹

b. Persons Excluded in the 15 Count. An adviser is not required to count the following investors towards the 15 client threshold for the purposes of Rule 203(b)(3)-2:

(i) The hedge fund manager itself in its capacity as a general partner to a limited partnership or managing member to a limited liability company;⁵⁰

(ii) Inside personnel of the hedge fund manager that invest in the “private fund” and who satisfy the “knowledgeable employee” definition as described in Rule 205-3(d)(1)(iii).⁵¹

C. Question Three: Determining Assets Under Management

1. Generally

An adviser must have at least US\$25 million of assets under management to be eligible to register with the SEC.⁵² Note, that at US \$25 million or more of assets under management, it is permissible for an adviser to register with the SEC, but that it is not mandatory. It becomes mandatory if the adviser manages US\$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

⁴⁹ Release no. IA-2333, at 25, note 248.

⁵⁰ Rule 203(b)(3)-2(a) under the Advisers Act; Release No. IA-2333, at 21, note 193.

⁵¹ Rule 203(b)(3)-2(a) under the Advisers Act. The term “knowledgeable employee” with respect to any covered company (i.e. a 3(c)7 or 3(c)1 private investment company) means any natural person who is (i) Executive Officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the Covered Company or an Affiliated Management Person of the Covered Company; or (ii) an employee of the Covered Company or an Affiliated Management Person of the Covered Company (other than an employee performing solely clerical, secretarial or administrative functions with regard to such company or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of such Covered Company, other Covered Companies, or investment companies the investment activities of which are managed by such Affiliated Management Person of the Covered Company, provided that such employee has been performing such functions and duties for or on behalf of the Covered Company or the Affiliated Management Person of the Covered Company, or substantially similar functions or duties for or on behalf of another company for at least 12 months. See the Company Act, Rule 3(c)5.

⁵² Sec. 203(a)(1)(A) of the Advisers Act.

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

- Family assets.⁵³
- Proprietary capital of the hedge fund manager.⁵⁴
- Capital contributions from inside personnel of the hedge fund manager.⁵⁵
- Assets attributable to non-US investors.⁵⁶

III. Consequences of Registration: Compliance with the Advisers Act – Certain Rules to Consider

An adviser that is registered as an investment adviser with the SEC is required to comply with the various provisions under the Advisers Act and the highlights can be summarized as follows:⁵⁷

A. Written Compliance Program (Rule 206(4)-7 under the Advisers Act)⁵⁸

Rule 206(4)-7 under the Advisers Act requires a registered investment adviser to adopt a written compliance program and appoint a Chief Compliance Officer who is responsible for implementing and administering such program. It 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;⁵⁹

⁵³ An adviser is permitted, but not required, to include the value of its family and proprietary securities portfolios in calculating its assets under management. An adviser may construe the investments of these inside personnel and their families as proprietary or family assets for purposes of calculating its assets under management. See Release No. IA-2333, at 21, note 195.

⁵⁴ Release No. IA-2333, at 20, note 191.

⁵⁵ *Id.*

⁵⁶ Release No. IA-2333, at 20-21, notes 191 and 195.

⁵⁷ A separate memorandum prepared by Tannenbaum Helpern Syracuse & Hirschtritt LLP providing an overview of the compliance requirements imposed by the Advisers Act and other statutes entitled "Compliance and Filing Requirements for Fund Managers that Are Registered Investment Advisers" (December 2004) is readily available. There is a more comprehensive discussion on compliance and the written compliance program needed in a separate memorandum prepared by the law firm entitled "SEC Adopts Final Rules Requiring Registered Investment Advisers to Implement Written Compliance Program" (January 7, 2004). See the law firm's website www.thshlaw.com to obtain a copy of either or both, or contact the author directly at 212.508.6701 or tannenbaum@thshlaw.com.

⁵⁸ See Securities and Exchange Commission, "Compliance Programs of Investment Companies and Investment Advisers" final rule. 68 Fed. Reg. 74714-74730 (December 24, 2003).

⁵⁹ 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.

- 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;⁶⁰
- Proprietary trading of the investment adviser and personal trading activities of supervised persons;⁶¹
- The accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements;⁶²
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;⁶³
- 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;⁶⁴
- Marketing advisory services, including the use of solicitors;⁶⁵
- Processes to value client holdings and assess fees based on those valuations;

⁶⁰ An investment adviser that engages in the use of soft dollars (whether within the exceptions under Sec. 28(e) of the Securities Exchange Act of 1934 or outside Sec. 28(e)) is required to disclose its 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).

⁶¹ Pursuant to Sec. 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.

⁶² 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).

⁶³ 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.

⁶⁴ 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).

⁶⁵ 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.

- Safeguards for the privacy protection of client records and information;⁶⁶ and
- Business continuity plans.⁶⁷

B. Code of Ethics (Rule 204A-1 under the Advisers Act)⁶⁸

A registered investment adviser is required to adopt and to enforce a Code of Ethics applicable to its supervised persons.⁶⁹ 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”⁷⁰; and

⁶⁶ 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.

⁶⁷ 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.

⁶⁸ 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).

⁶⁹ 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 Sec. 202(a)(25) of the Advisers Act.

⁷⁰ The term “access person” is a functional definition that refers to any supervised person that performs the following functions:

- (i) 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
- (ii) 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.

“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. 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

- Pre-clearance requirements for “access persons” of any personal investments in IPOs and private placements.

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

1. Generally

A registered adviser that compensates third parties that solicit investors is required to comply with Rule 206(4)-3 under the Advisers Act. Rule 206(4)-3 states that any cash referral fee may only be paid if 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 adviser’s instructions and the Advisers Act and Rules thereunder; and the investor must acknowledge existence of the agreement. In addition, a broker dealer charged with soliciting investors should be aware and understand its own responsibilities under Rule 206(4)-3.

2. Written Agreement

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, the adviser 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. The adviser 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.

Finally, it is paramount that an adviser obtain and maintain the written acknowledgements from investors who have been solicited because the SEC is requiring hedge fund managers to affirmatively disclose whether any investor has been solicited by third parties.⁷¹ As a result, advisers can expect SEC examiners to request copies of

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.

⁷¹ See Sec. 7.B., Schedule D of Part I of Form ADV.

written acknowledgements of investors during SEC examinations if they have responded that investors are solicited by third parties.

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

A registered investment adviser is prohibited from charging its clients a performance fee or performance allocation pursuant to Sec. 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 Act.⁷² Unregistered investment advisers are not subject to this restriction.⁷³ Certain grandfathering provisions apply so as not to disrupt exiting relationships as advisers register.⁷⁴

A registered investment adviser, whether located within the US or outside the US, 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-US domiciled fund regardless of whether or not such fund has US investors.⁷⁵

E. Extent of Compliance with the Advisers Act by Non-US Based Registered Investment Adviser

1. Generally

In general, even though the substantive provisions of the Advisers Act do not apply to non-US based registered advisers, a non-US based registered adviser is obligated to comply with certain provisions under the Advisers Act.⁷⁶ A non-US based registered

⁷² Rule 205-3(a) under the Advisers Act. Under Rule 205-3(d)(1) a “qualified client” includes persons with a minimum net worth of at least \$1,500,000 or assets under management of not less than \$750,000, a qualified purchaser as defined in Rule 144A and certain senior executives of the adviser.

⁷³ Sec. 205(a) under the Advisers Act.

⁷⁴ In recognition of the potentially disruptive effect on pre-existing investor relationships, the SEC has adopted proposed Rule 205-3(c)(2) to permit certain investors (i.e. investors prior to February 10, 2005) 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. See 69 Fed. Reg. at 45186, note 156. Also, a “grandfathered investor” is permitted to make additional contributions to the fund without having to satisfy the qualified client criteria and the grandfathering extends to clients in managed accounts of the adviser. Release No. IA-2333, at 25. Lastly, note that if an adviser 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” wishes to invest in the new fund, the grandfathering does not carry over and such a “grandfathered investor” would be required to satisfy the qualified client criteria described in Rule 205-3(d)(1) under the Advisers Act before the adviser could charge a performance fee.

⁷⁵ Release No. IA-2333, at 23, note 221.

⁷⁶ Release No. IA-2333, at 22. The extraterritorial application of the Advisers Act is limited under Rule 203(b)(3)-2(c) in situations when the adviser’s principal place of business is outside the United States and if the fund it manages is organized under the laws of a country other than the United States. Rule 203(b)(3)-2(c) under the Advisers Act; Release No. IA-2333, at 22, note 210. The condition that a pooled investment vehicle must be domiciled outside the US implies that the limitation of the extraterritorial application of the Advisers Act will not apply if the non-US domiciled fund manager is operating a US

adviser remains subject to the anti-fraud provisions under the Advisers Act in the same manner as a US based adviser.⁷⁷ It is a misnomer to refer to this as “registration lite” because in fact the registration process for US and non-US advisers is precisely the same. Using the phrase “compliance lite” would seem to be more accurate. In any event, as to non-US advisers, the following applies:

- The record keeping 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 US client or related securities transactions.⁷⁸
- The record keeping 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-US clients.⁷⁹
- The Code of Ethics to the extent the non-US based adviser must retain its access persons’ personal securities reports (Rule 204A-1 under the Advisers Act.)⁸⁰
- A non-US based hedge fund manager that registers with the SEC remains subject to examination by the SEC Staff.⁸¹ During the examination, the registered non-US 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.⁸²

2. Excluded from Compliance with the Advisers Act.

Significantly, the SEC Staff has delineated those provisions that are inapplicable to non-US advisers with respect to their non-US clients. Non-US advisers that operate non-US domiciled are not required to comply with the following:

- The written compliance program (Rule 206(4)-7)⁸³
- The custody rule (Rule 206(4)-2)⁸⁴
- The proxy voting rule (Rule 206(4)-6)⁸⁵
- The advertising rule (Rule 206(4)-1)⁸⁶

domiciled fund. As such, a non-US based fund adviser that is operating a US-feeder that has fifteen or more US clients and is therefore required to register with the SEC could potentially be exposed to full compliance with the Advisers Act.

⁷⁷ Release No. IA-2333, at 22-23, note 215.

⁷⁸ Release No. IA-2333, at 23, note 216.

⁷⁹ *Id.*

⁸⁰ Release No. IA-2333, at 23.

⁸¹ Release No. IA-2333, at 23, note 217.

⁸² Release No. IA-2333, at 23, note 217. Sec. 204 of the Advisers Act authorizes the SEC examine all records of any registered adviser. *Id.*

⁸³ 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-US based adviser is not required to appoint a chief compliance officer.

⁸⁴ Release No. IA-2333, at 23, note 219.

⁸⁵ Release No. IA-2333, at 23, note 220.

- The solicitation rule with respect to non-US investors (Rule 206(4)-3.)⁸⁷
- The “brochure rule” with respect to both US investors and non-US investors (Rule 204-3)⁸⁸

The rationale for these exclusions is that a non-US adviser may treat its non-US domiciled “private fund” (and not the fund’s investors) as its client for most purposes under the Advisers Act.⁸⁹

IV. Other Issues

A. 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 investment adviser’s supervision and control and therefore constitute “persons associated with” the registered investment adviser. In that case, the SEC is able to enforce the requirements of the Advisers Act against both the registered investment adviser and 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-US 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”).⁹⁰ Again, the argument for the SEC Staff 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. But note the discussion above with regard to non-US advisers of “private funds.”

⁸⁶ Release No. IA-2333, at 23, note 221.

⁸⁷ A non-US based investment adviser that uses a third-party to solicit US investors is required to obtain and maintain written acknowledgements from US investors in accordance with Rule 206(4)-3 under the Advisers Act.

⁸⁸ “[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 23, note 221.

⁸⁹ Release No. IA-2333, at 22-23.

⁹⁰ ABA Letter, at 30, note 19. See, e.g., Uniao de Banco de Brasileiros S.A., SEC Staff letter (July 28, 1992); Mercury Asset Management plc, SEC Staff letter (Apr. 6, 1993) (“Mercury”); Kleinwort Benson Investment Management Limited, et al., SEC Staff letter (Dec. 15, 1993); Murray Johnstone Holdings Limited, et al., SEC Staff letter (Oct. 7, 1994); ABN AMRO Bank N.V., et al., SEC Staff letter (July 1, 1997) (“ABN AMRO”); and Royal Bank of Canada, et al., SEC Staff letter (June 3, 1998) (“RBC”).

B. Trading Issues—Principal Transactions and Rebalancing

The SEC Staff 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 Sec. 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 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 SEC Staff states that whether or not Sec. 206(3) applies to such transactions "depends upon all of the facts and circumstances."

C. The Use of Offshore Prime Brokers

A qualified custodian under the Custody Rule⁹¹ 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.⁹² 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.

D. Amortization of a Fund's Start-Up Costs

In adopting the 2003 amendments to the Custody Rule, the SEC 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.⁹³ The 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.

E. Record Retention Using an Administrator

A third-party administrator ("Administrator") of a registered investment adviser may maintain the books and records required to be kept under Rule 204-2 under the

⁹¹ See the Advisers Act, Rule 206(4)-2(c)(3)(iv).

⁹² ABA Letter, at 34. See also, Rule 206(4)-2(c)(3)(iv).

⁹³ ABA Letter, at 34. See also Rule 206(4)-2(b)(3).

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 (as opposed to 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 SEC Staff 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 Sec. 204 of the Advisers Act.

V. Conclusion

The new investment adviser registration rules issued by the SEC, effective February 1, 2006, seek to impose controls on investment advisers given the importance of that segment in the global financial community. The rules are complex and need to be understood so as not to run afoul of them. At this point it remains to be seen if additional rules will follow that may impede the investment process itself (such as, without limitation, limits on leverage, short selling, swaps.) The SEC has indicated that it has no intention of doing that.

Appendix 1

Certain Rule and Regulations Promulgated under the Investment Advisers Act of 1940

1. Rule 203(b)(3)-1 Definition of “Client” of an Investment Adviser

Preliminary Note to Rule 203(b)(3)-1

This rule is a safe harbor and is not intended to specify the exclusive method for determining who may be deemed a single client for purposes of section 203(b)(3) of the Act.

(a) General.

For purposes of section 203(b)(3) of the Act [15 U.S.C. 80b-3(b)(3)], the following are deemed a single client:

(1) A natural person, and:

(i) Any minor child of the natural person;

(ii) Any relative, spouse, or relative of the spouse of the natural person who has the same principal residence;

(iii) All accounts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries; and

(iv) All trusts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries;

(b) Special Rules.

For purposes of this section:

(1) An owner must be counted as a client if the investment adviser provides investment advisory services to the owner separate and apart from the investment advisory services provided to the legal organization, Provided, however, that the determination that an owner is a client will not affect the applicability of this section with regard to any other owner;

(2) An owner need not be counted as a client of an investment adviser solely because the investment adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters;

(3) A limited partnership is a client of any general partner or other person acting as investment adviser to the partnership;

(4) Any person for whom an investment adviser provides investment advisory services without compensation need not be counted as a client; and

(5) An investment adviser that has its principal office and place of business outside of the United States must count only clients that are United States residents; an investment adviser that has its principal office and place of business in the United States must count all clients.

(c) Holding Out.

Any investment adviser relying on this section shall not be deemed to be holding itself out generally to the public as an investment adviser, within the meaning of section 203(b)(3) of the Act [15 U.S.C. 80b-3(b)(3)], solely because such investment adviser participates in a non-public offering of interests in a limited partnership under the Securities Act of 1933.

2. Rule 203(b)(3)-2 Methods for Counting Clients in Certain Private Funds

- a. For purposes of section 203(b)(3) of the Act, you must count as clients the shareholders, limited partners, members, or beneficiaries (any of which are referred to hereinafter as an "owner") of a private fund as defined in paragraph (d) of section Rule 203(b)(3)-1, unless such owner is your advisory firm or a person described in paragraph (d)(1)(iii) of section Rule 205-3.
- b. If you provide investment advisory services to a private fund in which an investment company registered under the Investment Company Act of 1940 is, directly or indirectly, an owner, you must count the owners of that investment company as clients for purposes of section 203(b)(3) of the Act.
- c. If you have your principal office and place of business outside the United States, you may treat a private fund that is organized or incorporated under the laws of a country other than the United States as your client for all purposes under the Act, other than sections 203, 204, 206(1) and 206(2).