

Client Alert

A report
for clients
and friends
of the firm

December 2005

SEC Provides Guidance on Registration of Hedge Fund Advisers

On December 8, 2005, the Division of Investment Management of the Securities and Exchange Commission issued interpretive guidance in relation to rules adopted by the SEC last year that will require the registration of many hedge fund advisers by February 1, 2006. The guidance is in the form of responses to questions submitted to the Division by the Subcommittee on Private Entities of the American Bar Association in a letter dated June 23, 2005 (the "ABA Letter"), and comes just as hedge fund advisers that are required to register under the new rules should be filing their registration application electronically through the Investment Adviser Registration Depository (IARD). To ensure that applications are processed by the February 1, 2006 registration deadline, Form ADV Part I should be submitted by December 15, 2005. Please be aware that access to the IARD system may be limited during the last two weeks of December and the first week of January 2006 due to maintenance. A schedule for IARD availability can be found at www.iard.com.

The following provides a brief summary of those of the Division's responses that may be of particular significance to hedge fund advisers still considering their registration obligations under the new rules:

Redemptions within 2 years

Under the SEC's hedge fund adviser registration rules, the adviser to a "private fund" is required to look-through the private fund and count each investor in the "private fund" as a client. If the adviser has more than 14 clients during any 12-month period, it may be required to register with the SEC. Generally speaking, however, a fund is not a "private fund" if it imposes at least a two year lock-up on investments made on or after February 1, 2006. The Division

stated that the minimum two year lock-up is two years after the date of issue of an interest. For example, in order for the two year lock-up exemption to apply, an investor who makes an investment in a fund on January 1, 2007 cannot redeem that investment until, at the earliest, January 1, 2009.

Redemptions by Insiders

The two year lock-up period, if relied upon by a hedge fund adviser to avoid registration, must also apply to interests in the fund held by the fund's advisers, general partners and knowledgeable employees. However, in recognition that many advisers receive compensation in the form of deferred fees and allocations, the Division indicated that it would not recommend enforcement action against an adviser that failed to register solely because it did not treat the withdrawal of such deferred fees or allocations within two years of the date of deferral or accrual as redemptions for purposes of the definition of "private fund."

Redemptions by non-US Investors

The Division disagreed with the ABA Letter's proposal that an offshore fund advised by an offshore adviser be able to apply the two year lock-up requirement only to its US investors (thus allowing non-US investors to redeem their interests sooner) without causing the fund to fall within the definition of a "private fund." Accordingly, if a fund with both US and non-US investors permits any investor to redeem its interest within two years of purchase, the fund will be deemed a "private fund."

Transfer Among Classes of a Fund

The Division stated that the transfer of an investor from one class of a fund to another class within two years of investment may, depending on the particular facts, constitute a redemption, thus causing the fund to be a "private fund." However, in the Staff's opinion, a transfer from one class to another class would not be considered a redemption if the two classes share the same underlying portfolio of

investment securities and provide investors with the same redemption rights.

Extraordinary Events

The ABA Letter noted that a fund may allow an investor to redeem its interest within two years of the issue of such interest and not cause the fund to be a "private fund" if there are "extraordinary" events, and requested guidance from the Division in relation to the meaning of "extraordinary." The Division responded that the dissolution or liquidation of the investor may be considered "extraordinary" if the dissolution or liquidation is bona fide. However, the Division stated that a fund with investors that had negotiated for redemption rights triggered by significant withdrawals of capital from the fund by the adviser or its personnel would be considered to be a "private fund."

Registration of Subadvisers

The Division took a no-action position with respect to an offshore subadviser to a private fund that does not register with the SEC, provided that: (1) the subadviser is hired (and subject to be discharged) by the private fund's adviser that is registered with the SEC; (2) the subadviser is not otherwise required to register; (3) the subadviser is unaffiliated with the primary adviser to the fund; (4) written disclosure is provided to investors that the fund's assets may be managed by offshore subadvisers not registered with the SEC; and (5) at the time the subadviser is hired (and at the time any additional assets of the fund are allocated to the subadviser for management) the unregistered offshore subadviser does not manage more than 10% of the fund's total assets.

Registration of General Partner or Managing Member

The Division indicated that a special purpose vehicle (SPV) formed to act as a private fund's general partner or managing member and that has no employees or other persons acting on its behalf other than officers, directors, partners or employees of the adviser, is not required to register, provided that: (1) all of the investment advisory activities of the SPV are subject to the Investment Advisers Act of 1940 and the rules thereunder; and (2) the SPV is subject to examination by the SEC.

Effective Date of Registration

In response to a proposal that a new registrant be deemed to have met the February 1, 2006 deadline for registration if it files its Form ADV by January 13, 2006, the Division urged advisers that will be required to register as a result of the new rules to submit applications by no later than December 15, 2005. However, in recognition that many advisers will be reviewing the new guidance, the Division indicated that, if an application is filed by January 9, 2006, it "will

endeavor", but will not guarantee, to act upon the application by February 1, 2006.

First Annual Updating Amendment

In order to ensure that new registrants' first annual updating amendment is due by March 31, 2007, rather than March 31, 2006, Form ADV filings made after November 20, 2005 will not be declared effective before January 3, 2006, unless the filer requests earlier approval.

The Division's responses to the ABA Letter also provided guidance on other topics of interest to hedge fund advisers, such as principal transactions, Form ADV, the SEC's custody rule and record retention. These matters will be covered in our next Client Alert, which will provide an in-depth discussion of the Division's new guidance and its implications for hedge fund advisers.

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The Hedge Fund Group is based in our New York office and coordinates closely with our Investment Management, Private Equity, Tax and ERISA practices. The Group includes a core group of experienced legal practitioners who have represented hedge funds and managers for more than 20 years. For more information about this practice area, contact:

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