FEBRUARY 2, 2005

SEC EXPANDS INVESTMENT ADVISOR REGISTRATION FOR HEDGE FUND MANAGERS

Investment Advisors Act Section 203(b) exempts from registration under the Act those investment advisors who, during the preceding twelve months, had fewer than fifteen clients and did not hold itself out generally to the public as an investment advisor. Advisors Act Rule 203(b)(3)-1 provided a safe harbor so that a fund advisor need only count the fund as one client rather than "looking through" the fund to count each of the investors.

That safe harbor is now, for most hedge funds and potentially some private equity and venture capital funds, gone. As a result of recent changes by the SEC, for purposes of determining the number of clients under Section 203(b)(3), fund managers must look through and count the owners of each "private fund" managed by the fund manager.

What is a private fund?

The SEC intended the definition of "private fund" to cover traditional hedge funds, but not venture capital or private equity funds. A "private fund" is any company:

- that would be an investment company under the 1940 Act but for the exceptions under Section 3(c)(1) or 3(c)(7) of the 1940 Act,
- that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests, and
- interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.

Since most funds will usually be unable to avoid the first and third point, a fund manager seeking to continue to avail itself of the safe harbor will need to focus on limiting investors' liquidity and the exceptions to the two year lock-up.

Are any redemptions permissible under the two year lock-up requirement?

The SEC's rule permits redemptions prior to the two year lock-up only for:

- events the fund manager finds after reasonable inquiry to be extraordinary. Such "extraordinary events" include:
  - continuing to hold the investment becomes impractical or illegal,
  - the investor's death or total disability,
  - key personnel at the fund adviser die, become incapacitated, or cease to be involved in the management of the fund for an extended period of time,
  - a merger or reorganization of the fund,
  - avoiding a materially adverse tax or regulatory outcome, or
  - prevent the fund's assets from being considered "plan assets" under ERISA.
- interests acquired through reinvestment of distributed capital gains or income.

The SEC cited other liquidating events that are permissible under the two year lock-up requirement, including:

- distributions payable to all owners, or a class of owners, in accordance with the fund's governing documents, or
- an investor's transfer of its interest to a new investor.

When are the new rules effective?

Fund advisers must comply with the new rules by February 1, 2006, which includes having its Advisors Act registration effective and all required policies, procedures and personnel in place.

For purposes of determining whether the two year lock-up applies, only investments in funds on or after February 1, 2006, whether by new or existing investors, must be subject to a two year lock-up. For fund managers relying on the two year lockup exclusion, any investments prior to February 1, 2006 in those funds need not be subject to the lock-up.