SEC Issues Interpretations of Private Fund Adviser Registration Rules

Certain advisers of private investment funds will be required to register under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), no later than February 1, 2006 to comply with rules adopted by the Securities and Exchange Commission in December 2004 (the “Registration Rules”). The staff of the SEC’s Division of Investment Management (the “Staff”) recently issued interpretive guidance relating to the Registration Rules that may affect whether a private fund adviser must register. In providing this guidance, the Staff has clarified important aspects of the definition of a “private fund” and other matters relevant to advisers that are determining whether they are required to register. This Hedge Fund Alert highlights the Staff’s latest guidance for private fund advisers affected by the February 1, 2006 deadline, and summarizes additional regulatory issues that should be reviewed by all advisers that are registered with the SEC.

Background

In recent years many firms have enjoyed an exemption from regulation by the SEC under the Advisers Act that provides that an adviser may remain unregistered if it has no more than 14 clients in any 12-month period and does not hold itself out to the public as an investment adviser. This exemption, sometimes referred to as the “private adviser” exemption, was narrowed in December 2004 when the SEC adopted the Registration Rules. Effective February 1, 2006, the Registration Rules require every adviser to look through each “private fund” it manages to count each of the fund’s investors as a client for purposes of the 14-client maximum. Certain aspects of the Registration Rules – including the definition of a “private fund” – have

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1 SEC Release No. IA-2333 (December 2, 2004), as more fully described in Goodwin Procter’s December 10, 2004 Hedge Fund Alert at:
http://www.goodwinprocter.com/publications/HF_HFAdvisorRegRequirements_12_10_04.pdf. The Registration Rules have been the subject of considerable controversy and are currently the subject of litigation challenging the SEC’s authority to adopt such rules; however, it is likely that the Registration Rules will take effect before the controversy or litigation is resolved.

2 Section 203(b)(3) of the Advisers Act provides the exemption for advisers with up to 14 clients; Rule 203(b)(3)-1(a) under the Advisers Act provides that a partnership, limited liability company or other type of investment fund (other than a “private fund”) will be deemed to be a single client so long as investment advice is provided based on the fund’s investment objectives, rather than on the individual investment objectives of the fund’s owners.
raised interpretive questions, a number of which were addressed by the Staff in a letter released last month (the “SEC Response”).

**Definition of “Private Fund”**

Under the Registration Rules, the term “private fund” does not refer to all unregistered investment funds, but specifically means a fund that (a) is not required to register under the Investment Company Act of 1940, as amended, because it meets the requirements under Section 3(c)(1) or (7) of that Act and (b) “permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests” (excluding redemptions upon the occurrence of “extraordinary” events and redemptions of interests acquired through the reinvestment of distributed capital gains or income). The SEC Response provides the following additional guidance regarding the two-year lockup requirement:

- **Applicable to All Investors.** The two-year lockup must apply to all investments in a particular fund, including all investments made by non-U.S. persons or by the manager and its personnel.

- **Calculation of Period.** The two-year lockup must run through the second anniversary of the relevant investment in the fund – meaning, for example, that an investor who makes a capital contribution on January 1, 2007 could not be permitted to redeem on December 31, 2008, but would have to wait until January 1, 2009.

- **Transfers Among Classes.** A transfer from one class of interest in a fund to another class of the same fund will not be considered a redemption only if both classes share the same underlying portfolio of investments and provide investors with the same redemption rights. However, a transfer will be considered a redemption if either class had any investment not shared in identical proportion by the other class (e.g., illiquid investments held in “side pockets” or IPO securities in which “restricted persons” under applicable NASD rules may not invest.)

- **Transfers within Complex Structures.** In a complex fund structure involving subsidiary “blocker” entities or multiple master funds, transfers within the fund structure resulting from reallocations determined by the manager in accordance with a fund’s investment objectives will not be subject to the two-year lockup requirement provided that the redemption rights of the ultimate investors are subject to the two-year lockup.

- **Transfers by Gift or Secondary Market Transaction.** An investor who purchases fund interests in a secondary market transaction, or who

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3 The SEC Response was prepared by the Staff in reply to an inquiry letter from the American Bar Association Subcommittee on Private Investment Entities. Consistent with disclaimers included in other recent SEC staff responses to requests for guidance, the SEC Response notes that the guidance it provides is not a rule, regulation or official statement of the SEC, and that the SEC neither approved nor disapproved its content.
receives fund interests as a gift, retains the transferor’s investment date for purposes of the two-year lockup (so long as the transaction is not designed to circumvent the lockup requirement). Fund advisers should take care not to arrange or initiate any such transactions.

- **Investor Dissolution, Liquidation or Bankruptcy.** An “extraordinary” event upon which a redemption by an investor may be permitted (or required) includes an entity investor’s dissolution or liquidation, provided that upon reasonable inquiry the manager reasonably believes the liquidation or dissolution is *bona fide* and not designed to avoid the two-year lockup. The bankruptcy of an investor (whether an entity or an individual) is also an “extraordinary” event for these purposes.

- **Significant Capital Withdrawal by Adviser.** A significant capital withdrawal from a fund by the fund’s adviser or its affiliates does *not* qualify as an “extraordinary” event upon which a redemption by another investor would be permissible within the two-year period (although more typical “key personnel” redemption provisions are allowed under the Registration Rules).

- **Withdrawal of Incentive Fees/Allocations.** Fund advisers and general partners may redeem interests attributable to an incentive allocation/carried interest/compensation for services without regard to the two-year lockup.

**Subadvisers with Respect to “Private Funds”**

As noted above, the Registration Rules require all firms providing investment advice to “private funds” to look through the fund when counting clients for purposes of the private adviser exemption. The SEC Response reconfirms this requirement for all firms operating in the United States, but also establishes a new *de minimis* exception applicable to non-U.S. subadvisers with respect to private funds:

- **Onshore Advisers.** In determining whether or not it is required to register with the SEC, a fund subadviser operating in the United States must look through any “private fund” that invests any portion of its assets on the basis of advice provided by the subadviser. This look-through requirement applies even in cases where the fund’s sponsor retains the power to hire and fire the subadviser and where the proportion of the fund’s assets under the subadviser’s management is very small.

- **Offshore Advisers.** In contrast, an advisory firm located outside the United States will not be required to register with the SEC solely because it provides subadvisory services to a “private fund” in circumstances where: (a) the fund’s principal adviser is registered with the SEC and retains the power to hire and fire the subadviser; (b) the subadviser is not affiliated with the fund’s principal adviser; (c) the subadviser has investment authority with respect to no more than 10% of the fund’s assets at the time it is hired and at the time of any subsequent allocation.
of additional assets to it; and (d) the fund’s offering materials disclose that a portion of the fund’s assets may be managed by non-U.S. firms that are not registered with the SEC.

**Affiliated Entities**

- **Special Purpose Entities.** The SEC Response confirms that, in most cases, a special purpose entity acting as the general partner or managing member of a private fund will not have to register separately with the SEC. In such circumstances, the investment advisory activities of the special purpose entity would be subject to the Advisers Act as if the entity were a registered investment adviser, and the entity and its personnel would need to be under the supervision and control of the fund’s registered adviser.4

- **Non-U.S. Affiliates.** The SEC Response also confirms that non-U.S. affiliates of a registered adviser (whether or not the adviser is located in the United States) need not separately register with the SEC provided that they comply with the requirements of existing SEC no-action letters.5

**Additional Matters Addressed by the Staff**

The SEC Response also addresses the following matters, many of which may be of particular interest to advisers already registered with the SEC:

- **Custody Rule - Offshore Prime Brokers.** In the context of the custody rule under the Advisers Act, the SEC Response reconfirms that a fund’s prime broker located outside the United States would be treated as a “qualified custodian” under that rule only if it segregates the fund’s assets from its own proprietary assets in accordance with the rule (notwithstanding local practices).6 Advisers should carefully review the practices of their funds’ prime brokers to ensure compliance with the requirements of the Advisers Act.

- **Custody Rule - Quarterly Statements/GAAP Financials.** One of the requirements under the Advisers Act custody rule is that a fund’s

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4 A firm that establishes a special purpose entity to act as a fund’s general partner or manager may also consider structuring its responsibilities such that they do not include duties that may be deemed to be investment advisory activities regulated by the Advisers Act.

5 Among other conditions, these no-action letters require the non-U.S. affiliate and certain of its employees to be considered “associated persons” of the SEC-registered adviser and be subject to recordkeeping and other requirements under the Advisers Act.

6 Rule 206(4)-(2) under the Advisers Act generally requires a registered investment adviser deemed to have custody of a fund’s securities and other assets to maintain them with a “qualified custodian,” which includes most banks, broker-dealers and futures commission merchants, as well as foreign financial institutions that segregate customer assets from their own proprietary assets. Certain non-U.S. prime brokers do not currently segregate customer assets (such as cash balances) in all circumstances.
custodian send quarterly account statements to all investors in the fund unless the fund is audited annually and its financial statements are prepared in accordance with generally accepted accounting principles (“GAAP”) and distributed to investors in accordance with the rule. In the SEC Response, the Staff notes that, although many funds amortize start-up costs over a period of years so as to ensure that such costs are not borne solely by the fund’s initial investors, this practice typically results in the issuance of a qualified audit opinion with respect to the fund’s financial statements. Advisers should note the SEC Response indicates that financial statements accompanied by a qualified audit opinion are not GAAP-compliant and, consequently, that the quarterly account statement requirement continues to apply. Advisers should also note that if a fund does not issue GAAP-compliant audited financial statements within the time period required by the custody rule, the fund may not use the pooled fund exemption that would permit it to hold uncertificated privately offered securities.

• **Record Retention – Third-Party Provider.** The SEC Response confirms that an adviser will remain in compliance with the recordkeeping requirements of the Advisers Act (which generally require that an adviser’s records be kept at its principal office for at least two years) even if certain records are maintained by a third-party fund administrator/recordkeeper at a location other than adviser’s offices, provided that the records can be produced promptly upon request by the SEC staff. This interpretation supersedes earlier Staff positions to the contrary.

• **Family Investment Funds.** Consistent with the position taken by the SEC in adopting the Registration Rules, the Staff notes in the SEC Response that the definition of a “private fund” includes an investment fund owned solely by members of the same family. However, the SEC Response confirms that an adviser will not be required to register with the SEC solely because it provides services to a family investment fund if the fund was not offered based on the expertise of the adviser, provided that this is clear from the particular facts and circumstances of the case.

• **Records of Offshore Funds.** The SEC Response confirms that the books and records of a non-U.S. fund governed by an independent board of directors will not be considered the books and records of the fund’s

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7 In some limited circumstances (e.g., if the fund’s start-up expenses are not material in relation to the size of the fund), auditors may give an unqualified audit opinion.


9 Advisers to family investment funds should note in particular that, for purposes of counting clients, family members living in the same household (as well as accounts or trusts established for their benefit) may generally be considered a “single client” under Rule 203(b)(3)-1(a)(1), and an individual investing in more than one private fund advised by the same adviser need not be counted twice.
registered adviser (and, consequently, will not be subject to SEC examination) as long as neither the adviser nor any of its related persons serves as the fund’s general partner or managing member or in any other similar capacity.

- *Form ADV.* In response to Form ADV’s request for information regarding an adviser’s private funds, the SEC Response confirms that an adviser should report the names and assets of both feeder funds and the master fund in any master-feeder structure it maintains.\(^{10}\) The SEC Response suggests that an adviser may wish to indicate for each feeder in the field on Form ADV that calls for a fund’s name that the feeder invests solely in a master fund. (This would avoid double counting of an adviser’s private fund assets under management, the amount of which may, at least in the short-term, play a role in determining SEC inspection priorities.)

**Issues Not Addressed by the Staff**

In the SEC Response, the Staff indicates that it is not in a position to address certain issues that have been raised regarding the application of Advisers Act requirements in the private fund adviser context, as summarized below:

- *Principal Transactions and Rebalancing.* The SEC Response declines to provide additional guidance regarding whether the advance notice and client consent requirements relating to principal transactions of the Advisers Act apply to periodic rebalancing transactions or to transactions involving funds in which the adviser or its personnel have an ownership interest. Instead, the Staff reaffirms that such transactions must be analyzed based on all of the relevant facts and circumstances.

- *Proxy Voting.* The SEC Response does not respond to questions raised with respect to whether a hedge fund manager may adopt (and disclose) a blanket policy not to vote proxies, based on its determination that the cost of voting proxies exceeds the expected benefit to fund investors in particular types of funds.

- *E-mail Retention.* The SEC Response does not address an adviser’s obligations to retain e-mail communications. However, SEC representatives have indicated in other contexts that such guidance will be forthcoming.

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\(^{10}\) This disclosure is required by Section 7.B of Schedule D. The Staff did not address whether it would consider revising or eliminating certain other questions relating to the percentage of clients solicited to invest in investment funds identified in Section 7.B of Schedule D, or the requirement that firms merely subadvising a private fund must describe it in that Section of Schedule D.
Additional Resources

Additional information concerning the Registration Rules is available in Goodwin Procter’s December 10, 2004 *Hedge Fund Alert* at: http://www.goodwinprocter.com/publications/HF_HFAdvisorRegRequirements_12_10_04.pdf.


If you would like additional information about the issues raised in this Alert, please contact:

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