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CLIENT ADVISORY

HENDERSON & LYMAN FINANCIAL SERVICES DIVISION - DECEMBER 20, 2005

NEW AND AMENDED INVESTMENT ADVISER ACT RULES AND PRIVATE INVESTMENT FUNDS

In October 2004, the Securities and Exchange Commission (the "SEC") adopted Rule 203(b)(3)-2 and amendments to existing rules under the Investment Advisers Act of 1940 (the "Advisers Act") that affect how managers or advisors to "private investment" funds will be required to count their clients for purposes of the Advisers Act. Previously, managers of and advisors to investment funds that invested in and traded securities were able to rely on §203(b)(3) of the Advisers Act and Rule 203(b)(3)-1 to avoid registration as an investment adviser under the Advisers Act.

I. Who Must Register

Under the Advisers Act, one who (i) had less than 15 clients during the course of the preceding 12 months, (ii) does not hold himself out generally to the public as an investment adviser and (iii) does not provide investment advice to a registered investment company is not required to be registered as an investment adviser under the Advisers Act.

New Rule 203(b)(3)-2 requires managers and/or advisers of private funds to look through the fund and count the fund's underlying investors as clients for purposes both of the 14-client threshold and to determine whether the manager must register as an investment adviser with the SEC.

For purposes of Rule 203(b)(3)-2, a private fund (hereinafter, a "Private Fund") is an entity:

- (i) That would be an investment company under §3(a) of the Investment Company Act of 1940 (the "Company Act") but for the exception provided from that definition by either §3(c)(1) or §3(c)(7) of the Company Act;
- (ii) That permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and
- (iii) Interests which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.

This definition of the term “Private Fund” was drafted to include most hedge funds while excluding private equity and venture capital funds. Although the term “hedge fund” does not have a universally accepted definition, for purposes of the Advisers Act and the amended rules thereunder, the term “hedge fund” refers to a private fund that invests, in whole or part, in securities. Thus, funds which invest and trade exclusively in futures contracts, other commodities, options on futures, forex instruments and/or some combination thereof are not included in the definition of private funds for purposes of the new and amended Advisers Act rules.

Accordingly, many of our clients, which manage and/or operate commodity pools, should not be impacted by Rule 203(b)(3)-2 and the other rule amendments.

Conversely, managers of and advisers to Private Funds will need to look through their fund clients to the underlying investors of those funds for purposes of determining whether they have more than 14 clients during any 12-month period. See Section IV below for additional information with respect to counting clients for purposes of the 14-client threshold and the private adviser registration exemption.

An adviser otherwise required to become registered (i) that is regulated or is required to be regulated in the state in which it maintains its principal office and place of business;¹ (ii) who does not manage at least \$25 million in assets; and (iii) does not serve as an investment adviser to an investment company registered under the Company Act, is not eligible to register as an investment adviser with the SEC. Such an adviser must look to applicable state investment adviser statutes and regulations to determine whether and when it is required to register as an investment adviser under state law. Note in this regard Advisers Act §222(d) which preempts a state from registering an investment adviser which does not maintain a place of business within the state and has had less than 6 clients during the preceding 12-month period who are residents of that state. Advisers whose assets under management equal or exceed \$30 million and who are otherwise required to register, must register with the SEC. For purposes of this threshold assets-under-management test, advisers must consider the aggregate value of the funds’ securities portfolios, as well as the value of each other (non-fund) clients’ securities portfolios. Advisers may exclude from this calculation proprietary assets held in a Private Fund and assets of non-U.S. investors. Advisers that provide advice with respect to securities as well as futures contracts, other commodities, options on futures and forex instruments should not include such other assets when calculating the value of assets under management for purposes of the \$25 million and/or \$30 threshold.

¹ Currently, Wyoming is the only state that does not have a statute for the regulation of investment advisers.

Despite the look-through provisions of Rule 203(b)(3)-1 and the other rule amendments which seemingly trigger registration requirements for managers of Private Funds, §203(b) of the Advisers Act provides various exemptions from the registration requirements. In particular, managers and advisers to funds that invest in futures contracts and/or other commodities and securities may be able to rely on an exemption from registration available to a person that is registered with the Commodity Futures Trading Commission (the “CFTC”) as a commodity trading advisor (a “CTA”), whose business does not consist primarily of acting as an investment adviser; provided that such person does not act as an investment adviser to a registered investment company or a small business development company.²

We anticipate that the §203(b)(6) exemption from registration for CFTC-registered CTAs is potentially helpful to managers that operate commodity pools and that also invest a portion of the funds’ assets in securities. Unfortunately, there is little information or guidance available to explain what the SEC considers to be business which does not consist primarily of acting as an investment adviser and as yet, no test has been articulated by the SEC or the courts with respect to this exemption.

II. The Redemption Provisions and the 2-Year Lock-Up

A Fund will not be considered to be a Private Fund if it does not permit investor redemptions within 2 years of making an initial or additional capital contribution. The 2-year lock-up period will be applicable to any new or additional capital contribution to a Private Fund made on or after February 1, 2006. Fund managers or advisers may use a first in, first out convention for determining the age of an investment or capital contribution for investors who make multiple capital contributions.

There are some exceptions to the redemption test. Rule 203(b)(3)-1(d)(2) provides that a fund may permit redemption of an ownership interest within 2 years of the investment or capital contribution and still not be considered a Private Fund if the redemption results from an extraordinary event, such as the owner’s death or total disability, or in the event key personnel of the manager leave, or upon a merger or reorganization of the fund. In addition, redemptions of interest acquired through the reinvestment of distributed capital gains or income prior to the expiration of the 2-year lock-up will not cause a fund to be deemed a Private Fund.

Moreover, a transfer by a Private Fund investor of his ownership interest in the Private Fund to a new investor in a secondary market transaction will not be deemed to be a redemption for purposes of the two-year lock-up.³ The redemption test will not restrict a Private Fund’s distributions made to investors or one or more classes of

² §203(b)(6) of the Advisers Act.

³ SEC Release IA-2333 (the “Adopting Release”), §II.E. and at note 242.

investors in accordance with the Private Fund's governing documents.⁴ However, it should be noted that the redemption test cannot be circumvented through any "side letter" arrangement.

III. Compliance Date

Rule 203(b)(3)-2 and most of the amendments to certain other rules under the Advisers Act became effective on February 10, 2005. The compliance date for investment adviser registration with the SEC is February 1, 2006 for advisers who intend to admit new investors into their Private Funds in February 2006. Those advisers who are required to register as investment advisers with the SEC should begin preparations and file their Form ADV as soon as possible in order to have their registration effective by February 1, 2006.

IV. Counting Clients

As described above, as a result of Rule 203(b)(3)-2, an adviser to a Private Fund will be required to count each Private Fund's investors, as well as any other clients the adviser has, for purposes of determining whether the private adviser exemption is available to it. However, the Private Fund look-through is prospective, not retroactive. Advisers are not required to count the investors a Private Fund may have had in the twelve months preceding February 1, 2006, for purposes of the 14-client threshold.

Moreover, advisers should note that certain types of investors do not need to be counted as clients for purposes of the 14-client threshold. The manager or adviser to a Private Fund does not need to be counted as a client for purposes of the 14-client threshold, regardless of the form of its investment in the Private Fund.⁵ In addition, certain knowledgeable advisory personnel who are "qualified clients" as defined in Rule 205(3)(d)(1) under the Advisers Act need not be separately counted as clients. Knowledgeable advisory personnel include:

- (i) An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the adviser; or
- (ii) An employee of the adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such adviser, provided that the employee has been performing such functions and duties for or on behalf of the

⁴ Adopting Release §II.E. and at note 241.

⁵ However, the specifically SEC cautioned against attempts to circumvent the 14-client threshold by making investors in the Private Fund partners or shareholders of the advisory firm. See Adopting Release.

adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.⁶

Rule 203(b)(3)-2 applies not only to managers of Private Funds, but also to managers of funds of funds and/or master funds that are themselves Private Funds. Consequently, the adviser of a Private Fund whose clients include one or more Private Funds must look through each Private Fund investor (an “Investor Fund”) and count the Investor Fund’s clients for purposes of the 14-client threshold. In the Adopting Release, the SEC noted that the adviser to a Private Fund would not be required to obtain information as to the identity of the Investor Fund’s investors or the exact number of such investors. Rather, the adviser to a Private Fund is only required to obtain, on a periodic ongoing basis, sufficient information from the Investor Fund to determine its (the adviser’s) registration obligations under Rule 203(b)(3)(2)-2. However, if an adviser to a Private Fund whose investors include (directly or indirectly) a registered investment company, each investor in such registered investment company must be counted as a client for purposes of Rule 203(b)(3)-2.⁷

Rule 203(b)(3)-2 also impacts offshore advisers or managers, i.e. those with a principal office and place of business located outside the United States. For purposes of the private adviser exemption and the 14-client threshold, offshore advisers must generally count each U.S. investor of a Private Fund (whether it is organized in the United States or an offshore jurisdiction) as a client. An offshore adviser to a Private Fund need only determine whether an investor is a U.S. or non-U.S. person (and consequently determine whether such investor is counted for purposes of the 14-client threshold) at the time the investment is made. Consequently, a non-U.S. person who subsequently becomes a U.S. person need not be counted towards the 14-client threshold.⁸

The definition of the term Private Fund specifically excludes a company: (i) whose principal office and place of business is outside the United States; (ii) that makes a public offering of its securities in a country other than the United States; and (iii) that is regulated as a public investment company under the laws of a country other than the United States.⁹ However, offshore funds that are listed on offshore exchanges are offshore public funds for purposes of Rule 203(b)(3)-1(d)(3). This exclusion must be examined carefully, however, as not all offshore funds that are listed on offshore exchanges are considered by the SEC to be public funds for purposes of Rule 203(b)(3)-1(d)(3).

⁶ Rule 205(3)(d)(1)(iii) promulgated under the Advisers Act.

⁷ Rule 203(b)(3)-2(b).

⁸ Although, the Adopting Release provides no further guidance on this point, if a non-U.S. person to a Private Fund subsequently becomes a U.S. person and makes another capital contribution to the Private Fund, that investor would presumably be required to be counted for purposes of the 14-client threshold.

⁹ Rule 203(b)(3)-1(d)(3) promulgated under the Advisers Act.

Despite the new look-through provisions of Rule 203(b)(3)-2, certain groups of people may continue to be counted as single clients for purposes of the 14-client threshold pursuant to Rule 203(b)(3)-1. The following persons may be deemed to be a single client for purposes of the threshold:

1. A natural person, and:
 - i. Any minor child of the natural person;
 - iii. 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 ... (1) are the only primary beneficiaries;
2.
 - i. A corporation, general partnership, limited partnership, limited liability company, trust (other than a trust referred to in paragraph ... (1)(iv)...), or other legal organization (any of which are referred to hereinafter as a “legal organization”) for which investment advice is based on the legal organization’s investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries (any of which are referred to hereinafter as an “owner”); and
 - ii. Two or more legal organizations referred to in paragraph ... (2)(i) ... that have identical owners.¹⁰

Note, however, that the legal organization referred to in 2(i) above does not include Private Funds as they are defined in new Rule 203(b)(3)-2.

Advisers should note that while this Client Advisory does not provide information or advice about state investment adviser statutes and registration requirements, in its Adopting Release, the SEC was clear that Rule 203(b)(3)-2 and the related rule amendments were intended only to affect the method of counting hedge fund advisers’ clients for purposes of the 14-client threshold and SEC registration requirements. The SEC noted specifically that it was not its “intention to amend advisers’ method of counting clients for other purposes”¹¹ and amended rules 222-2 and 203A-3 “to clarify that advisers and supervised persons may, for purposes of those

¹⁰ Rule 203(b)(3)-1 promulgated under the Advisers Act.

¹¹ Adopting Release, §II.J. and notes 268, 269 and 270.

rules, count clients as provided in rule 203(b)(3)-1 without giving regard to the look through requirements in Rule 203(b)(3)-2.”¹²

V. Related Amendments

In addition to the new Rule 203(b)(3)-2 which provides the look through for Private Funds, the SEC adopted other amendments to the certain rules promulgated under the Advisers Act in connection with that rule and the transition period for advisers that are affected by the rule.

Rule 204-2 under the Advisers Act specifies the books and records to be kept by SEC registered investment advisers, including those records which must be maintained to support the advisers’ use of past performance in materials sent for 10 or more persons.

The amended Rule 204-2 will permit an adviser that is required to register with the SEC as a result of the new look through provisions to use and disseminate its past performance for the period prior to which it became registered with the SEC, even if the adviser did not maintain all the records required by the SEC, so long as the adviser maintained: (i) all records required by the SEC to support past performance claims beginning February 10, 2005; and (ii) whatever records it possessed prior to February 10, 2005 to support its performance reports.

Rule 205-3 under the Advisers Act, which permits SEC-registered investment advisers to charge incentive fees to “Qualified Clients” (as defined in Rule 205-3(d)), was also amended. Generally, a Qualified Client is any person that: (i) has at least \$750,000 under management with the adviser, (ii) has a net worth (together, in case of a natural person, with assets held jointly with a spouse) of \$1.5 million, (iii) is a “qualified person” (as that term is defined in §2(a)(51)(A) of the Company Act or (iv) is a knowledgeable employee of the adviser.

Since existing investors in Private Funds managed by advisers who have not previously been required to register with the SEC as an investment adviser may not meet the Qualified Client criteria, Rule 205-3 has been amended to provide a grandfathering provision for those existing clients. The amended rule will permit the newly-registered adviser to continue to charge such investors an incentive fee and to permit such investors to make additional capital contributions or investments even if they do not meet the Qualified Client criteria. The amended rule also permits the adviser who will now be required to register as an investment adviser with the SEC to maintain and provide advisory services under existing advisory contracts with other (non-Private Funds) clients who have separately managed portfolios and who do not meet the Qualified Client criteria. In order to rely on the grandfathering provision of

¹² Adopting Release, §II.J.

this rule, a person must have been an existing investor in a Private Fund, or have had an existing advisory agreement with the advisor as of February 10, 2005.

The SEC also amended Rule 206(4)-2 under the Advisers Act, which addresses custody issues relating to client assets. The rule was amended to provide additional time to complete annual audits on behalf of advisers to funds of funds that provide investors with audited financial statements of the fund under the custody rule. Under the amended rule, advisers to funds of funds will have 180 days rather than 120 days to distribute the funds' audited financial statements.

VI. Conclusion

Certain money managers will be immediately impacted by the Rule 203(b)(3)-2 look-through provisions and the related amendments. However, the new rule, amendments and SEC comments regarding the rules have provided guidance on some, but not all matters affected by the rule change. As additional SEC's comments regarding these rules are released, unanswered questions for fund managers will hopefully be resolved. In the meantime, please contact us if you would like additional information about the new rule and amendments or about preparing for investment adviser registration.