

# European Corporate and Financial Briefing



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## U.S. Investment Adviser Registration: A Concise Summary For Offshore Hedge Fund Advisers

### Offshore Adviser Registration is Imminent

At this point, it is widely known that the U.S. Securities and Exchange Commission ("SEC") has issued new rules (the "Rule") requiring certain hedge fund advisers, including advisers who have their principal place of business located outside of the United States ("Offshore Advisers"), to register with the SEC as investment advisers pursuant to the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"). While the hedge fund industry continues to speculate as to whether the new Rule will be scaled back or eliminated as a result of legal challenges or the recent change in leadership at the SEC, the current reality is that Offshore Advisers that advise U.S. based hedge funds with more than 14 investors or offshore hedge funds with more than 14 U.S. investors will need to be registered with the SEC before **February 1, 2006**. As this date is quickly approaching, we have prepared the following concise summary to assist Offshore Advisers to hedge funds with evaluating the impact of the Rule on their businesses.

### Applicability of Rule to Offshore Hedge Fund Advisers

#### Who Needs to Register

An Offshore Adviser to hedge funds will need to register as an investment adviser with the SEC if:

- **U.S. Funds:** The Offshore Adviser provides advisory services to one or more U.S. based "private funds" with more than 14 investors or to other U.S. resident clients; and/or
- **Offshore Funds:** The Offshore Adviser provides advisory services to one or more offshore "private funds" with more than 14 U.S. residents as investors.

The SEC has defined "private fund" to cover most hedge funds. Specifically, the Rule defines a "private fund" as any company that (a) would be an investment company under the U.S. Investment Company Act of 1940, as amended but for Section 3(c)(1) or 3(c)(7); (b) has less than a 2-year lock up period; and (3) offers interests based on the investment advisory skills, ability or expertise of the investment manager.

#### Exceptions

- **2-Year Lock:** Offshore Advisers will not be subject to the Rule (*i.e.*, have to register with the SEC) if they only provide advisory services to hedge funds that have 2-year lock up periods<sup>1</sup>.

<sup>1</sup> In its adopting release, the SEC provided additional guidance concerning the application of the 2-year lock up period (e.g., allowing for redemptions during the lock-up period only in extraordinary circumstances) which is beyond the scope of this Advisory. The adopting release, *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Adviser Act Release No. IA-2333 (Dec. 2, 2004) (the "Adopting Release"), is available at <http://www.sec.gov/rules/final/ia-2333.htm>.

- **Offshore Public Funds:** Offshore Advisers will not be subject to the Rule if they only provide services to offshore publicly offered funds. The SEC has excluded from the definition of “private fund” any company that (a) has its principal office and place of business outside of the United States, (b) makes a public offering of its securities in a country other than the United States; and (c) is regulated as a public investment company under the laws of a country other than the United States.<sup>2</sup>

### **Practical Effect of SEC Registration**

#### Offshore Hedge Fund Clients Only – Limited Applicability of Advisers Act

An Offshore Adviser registered with the SEC that solely provides services to offshore hedge funds (and not to U.S. based hedge funds or to other U.S. resident clients) will only be required to comply with the following Sections of the Advisers Act and SEC rules under the Advisers Act:

- Registration - procedures for registration and amendment requirements (Section 203)
- Recordkeeping - requirement to maintain certain books and records (Section 204)
- Code of Ethics - no requirement to have a Code of Ethics but must retain its access persons’ personal securities reports (Rule 204A-1)
- SEC Exams - allowing for periodic examinations and sweeps by the SEC (Section 204)
- Anti-Fraud Provisions - the general anti-fraud provisions of the Advisers Act (Sections 206(1) and 206(2))

#### U.S. Hedge Fund Clients – Full Applicability of Advisers Act

An Offshore Adviser registered with the SEC that provides services to U.S. based hedge funds with more than 14 investors (or to other types of U.S. resident clients) will be subject all applicable provisions of the Advisers Act and SEC rules under the

Advisers Act. Together with the provisions mentioned above, these include the following:

- Code of Ethics – requiring a written code of ethics addressing conflicts of interest and insider trading (Section 204A)
- Advisory Contracts - requirements for content of advisory agreements and restrictions on charging performance fees (Section 205)
- Advertising Rule - requirements for and restrictions on content of advertising materials (Rule 206(4)-1)
- Custody Rule - requirements for advisers with custody of client assets (Rule 206(4)-2)
- Solicitation Rule - restrictions relating to cash payments to solicitors (Rule 206(4)-3)
- Proxy Voting - requiring written proxy voting policies and procedures (Rule 206(4)-6)
- Compliance Program Rule - requiring written policies and procedures and Chief Compliance Officer (Rule 206(4)-7)

### **Conclusion - Few Options for Offshore Advisers**

Unfortunately, the options available to Offshore Advisers to hedge funds that market to U.S. residents are limited under the Rule. Absent making significant business changes to avoid registration (i.e., instituting a 2-year lock or limiting activities to advising publicly offered and regulated investment companies), Offshore Advisers providing services to offshore hedge funds with more than 14 U.S. investors and /or U.S. hedge funds with more than 14 investors must register with the SEC. As noted above, it is possible to limit the impact of SEC registration by advising only offshore private funds. As a practical matter, this approach would require an Offshore Adviser that currently advises U.S. based funds to terminate its relationship with the U.S. funds and, if desired and/or necessary, restructure its offshore funds to accommodate U.S. investors.

<sup>2</sup> In the Adopting Release, the SEC indicates that certain hedge funds that are publicly offered outside of the United States would not be considered to be “regulated as a public investment company” for the purposes of the Rule. The SEC noted that a determination of whether a fund is a public investment company will depend on how the fund is viewed in other jurisdictions.

In order to meet the SEC's February 1, 2006 compliance deadline, Offshore Advisers will need to file their registration applications ***no later than early November 2005***.

As it may take several months to prepare the documentation needed for registration (SEC Forms ADV Part I and II and appropriate policies and procedures) we recommend that the registration process be initiated as soon as possible if not done so already.

If you would like further information regarding the new Rule or the SEC registration process, please contact:

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