

SEC adopts rule on registration of certain hedge fund advisers

Ludmila Mendez

Rule 203(b) (3)-2, which was adopted by the SEC on October 26, 2004, requires most private fund advisers to register with the Commission. Advisers must consider the number of investors in their funds, rather than the number of funds, to determine whether they are eligible for the exemption from registration available to advisers with 14 or fewer clients. Advisers to private funds in which a registered fund invests (i.e. a fund of hedge funds) must go one step further and count the investors in the registered fund as clients. Advisers who are no longer eligible for the exemption will have to register with the SEC by February 1, 2006.

The new registration requirements will give the SEC jurisdiction over many more hedge fund advisers, allowing the SEC greater access to information on advisers' operations. All registered investment advisers ("RIAs") are subject to examinations by SEC staff and must comply with the provisions of the Investment Advisers Act ("the Act"). Following is a summary of major provisions of the rule:

Definition of a "private fund"

The rule defines "private fund" as (1) one that would be an investment company but for the exceptions in Section 3(c) (1) or 3(c) (7) of the Investment Company Act; (2) permits investors to redeem their interests within two years of purchase; and (3) is offered based on the investment advisory skills, ability or expertise of the investment adviser.

The definition specifically exempts advisers to offshore publicly offered funds that (1) have their principal office and place of business outside the U.S.; (2) make a public offering of their securities outside the U.S.; and (3) are regulated as a public investment company under the laws of a country other than the U.S.

The two-year redemption test applies to each interest in the private fund and can be applied on a first in first out, or FIFO, basis. However, this requirement does not apply to interests acquired with reinvested dividends or to private equity and venture capital funds that allow redemptions under extraordinary circumstances.

Effect on performance-based fees

RIAs to private funds may charge performance-based fees to new investors only if they meet the standards of rule 205-3, which allows performance-based fees only for "qualified clients" (investors with a net worth of at least \$1.5 million or at least \$750,000 of assets under management with the adviser). The rule allows existing investors that are not "qualified clients" to retain their interest in that private fund

and to add to that account. However, it does not give them an exemption to open new accounts in that or other hedge funds.

Financial statements and required books and records

RIAs to funds of hedge funds will be able to satisfy their requirement to deliver audited financial statements within 180 days of their fiscal year end, instead of the requirement that they be delivered within 120 days of their fiscal year end.

Rule 204-2, which lists books and records requirements for all RIAs, will be amended to provide an exemption from the performance recordkeeping requirements for newly RIAs to private funds. Such RIAs will be required to retain whatever records they have that support the performance prior to their registration but will be excused from the recordkeeping rule to the extent that the records do not meet the requirements at the time of registration.

Code of ethics and compliance programs

RIAs are subject to rule 204A-1, which requires the adoption of a Code of Ethics tailored to the RIAs' business. The Code should state a standard of business conduct that the RIA requires of its employees and address personal securities trading and the protection of material non-public information.

RIAs are also subject to rule 206-4(7), which require the adoption of comprehensive policies and procedures and the appointment of a Chief Compliance Officer ("CCO"). Effective policies and procedures should be designed to prevent, detect, and correct violations. They should be tailored to the firm and provide for supervisory escalation of unresolved issues. The CCO must be knowledgeable of the federal securities laws

and the products and services offered by the firm. The CCO must also be independent and empowered with full responsibility and authority to develop and enforce a compliance program. SEC examiners will look to the CCO as an ally that will be expected to inform them of significant compliance violations.

Applicability to offshore advisers to private funds

The rule does not require advisers to offshore funds that have U.S. investors to “look through” the fund for any purposes under the Act, other than (1) the anti-fraud provisions and (2) determining the availability of the private adviser exemption. The release included a

reminder that U.S. advisers to private funds should not try to use the exception to evade the requirements of the Act by establishing a shell subsidiary in a foreign country to manage offshore hedge funds. Why? Because, under Section 208(d), advisers are prohibited from doing indirectly that which they cannot do directly.

For more information, please see IA Release No. 2333 (Dec. 2, 2004) available at www.sec.gov/rules/final.shtml. ■

The fair valuation debate continues

William Yip

Years of debate over the fair valuation practices of financial and non-financial assets and liabilities by accountants, valuation specialists, and investment professionals prompted the Financial Accounting Standards Board (the “FASB”) and the American Institute of Certified Public Accountants (the “AICPA”) to release an Exposure Draft, *Fair Value Measurements* (the “Exposure Draft”) and a Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (the “Practice Aid”), respectively.

The Exposure Draft provides guidance on how to measure *fair value* for both financial and non-financial assets and liabilities that are measured at fair value under other authoritative accounting pronouncements. The FASB initiated this project, in part, to address the differences in guidance that have created inconsistencies in the measurement of fair value and ultimately added to the complexity of financial reporting in accordance with generally accepted accounting principles. In response, the FASB developed a framework to further refine the fair value measurement objectives and its application under other pronouncements.

Likewise, the Practice Aid, which focuses on the valuation of privately-held-company equity securities, sets objectives which include the identification and encouragement of best practices in valuation. This guidance supplements recently released auditing guidance provided separately by SAS 101.

While the FASB’s response to comments on the Exposure Draft may result in further revisions, the implementation of these pronouncements may ultimately require participants in the alternative investment industry to revisit their policies and procedures with respect to the valuation of privately-held securities.

If adopted, the Exposure Draft and Practice Aid, which are described in greater detail below, could potentially impact or influence the application of securities pricing and the valuation of privately held securities. Upon becoming an official Statement of Financial Accounting Standard, the Exposure Draft will be the authoritative pronouncement on the subject of fair value measurement, while the Practice Aid will provide supplementary guidance on the valuation of privately held securities.

Exposure draft, *Fair Value Measurement*—highlights

The Exposure Draft focuses on the application of fair value measurements and expanded disclosure requirements. The Exposure Draft defines fair value as “the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties.”

If the Exposure Draft is adopted as proposed, it would require:

- “...the fair value of financial instruments traded in active dealer, markets where bid and asked prices are more readily and regularly available than closing prices, be estimated using bid prices for long positions