

On the Subject

Private Client

September 20, 2005

New Rules May Require Some Investment Advisers to Register with the SEC for the First Time

Changes Will Affect Some Family Offices; Compliance Deadline is February 1, 2006

In December 2004 the Securities and Exchange Commission (SEC) adopted new regulations and related interpretive positions that will require certain investment advisers to register with the SEC for the first time under the Investment Advisers Act of 1940 (the Advisers Act). The Advisers Act definition of “investment adviser” includes any person who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing or selling securities. Family offices and their principals may be considered to be “investment advisers” for purposes of the Advisers Act. Those primarily affected will be investment advisers previously exempt from SEC registration because they serve fewer than 15 clients. Investment advisers that have advised fewer than 15 clients during the preceding 12 months are not required to register with the SEC (although they may be required to register with a state securities commission) as long as they do not “hold themselves out” to the public as offering investment advisory services (a very broad concept that can include no more than word-of-mouth “marketing”). The new rules will require advisers to certain private investment funds, which have been treated as single clients, to “look through” the funds to the underlying investors in “counting to 15.” The compliance deadline for those investment advisers who now must register is February 1, 2006. We recommend, however, that covered advisers begin the registration process no later than October 2005.

“Private Funds” Require Look-Through

The new regulations change the counting rules only for advisers managing an entity defined as a “private fund.” Entities have private fund status when they meet all conditions of a three-part test.

If an entity relies on either the section 3(c)(1) or section 3(c)(7) “private investment company” exemptions under the Investment Company Act (the Company Act) to avoid registration with the SEC under the Company Act, it satisfies the first condition of the test. The Company Act requires certain entities engaged primarily in the business of investing in securities to register with the SEC. Section 3(c)(1) of the Company Act excludes from its scope any entity whose interests are beneficially owned by no more than 100 persons. Section 3(c)(7) of the Company Act excludes from its scope any entity whose interests are owned exclusively by persons who at the time of acquisition of such securities are “qualified purchasers.” The definition of “qualified purchaser” generally includes a person or a “family company” with at least \$5 million in specified kinds of investments; a trust as to which the trustee is, and each settlor was, a person with at least \$5 million in the specified investments; and a person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests at least \$25 million in the specified investments (see section 2(a)(51) of the Company Act and the SEC’s related rules). If the entity in question relies on either of these exemptions from registration—3(c)(1) or 3(c)(7)—it passes one test in qualifying as a “private fund.”

The second part of the private fund test, designed to separate private equity and venture capital funds (whose advisers the SEC did not want to regulate) from hedge funds, is that the entity permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests. The entity’s organizational documents generally will determine whether the owners have redemption rights and, if so, whether they are exercisable within the first two years of purchase.

The third and final condition of the private fund test is that interests in the entity must be offered or have been offered based on the investment advisory skills, ability or expertise of the investment adviser. While this is almost automatically met in the case of a fund whose interests are marketed to unrelated parties, investment advisers to a group of family investors might contend they were appointed or selected on a basis other than such skills, ability or expertise. Unfortunately, however, the

limited analysis the SEC has offered on the third part of the test as it would apply in such a scenario is not promising.

Deadline for New Registrants

As mentioned, the deadline for investment advisers required by these new regulations to register is February 1, 2006. The work entailed in registering and the ongoing compliance of a registered investment adviser is substantial and may be expensive. For example, the SEC has estimated that most advisers to private funds will spend approximately \$20,000 in professional fees and \$25,000 in internal costs to meet the February 1, 2006 compliance deadline. Additional compliance costs will be incurred on an ongoing basis. As a threshold matter, all investment advisers who are not presently registered with the SEC need to analyze whether any of their clients are private funds and, if so, whether this will mean they now have in excess of 14 clients. We have attached a flow chart to this *On the Subject* that summarizes the questions that need to be asked to make that analysis.

For assistance in “client counting” and other planning alternatives under the Investment Advisers Act of 1940, please contact your regular McDermott Will & Emery lawyer or:

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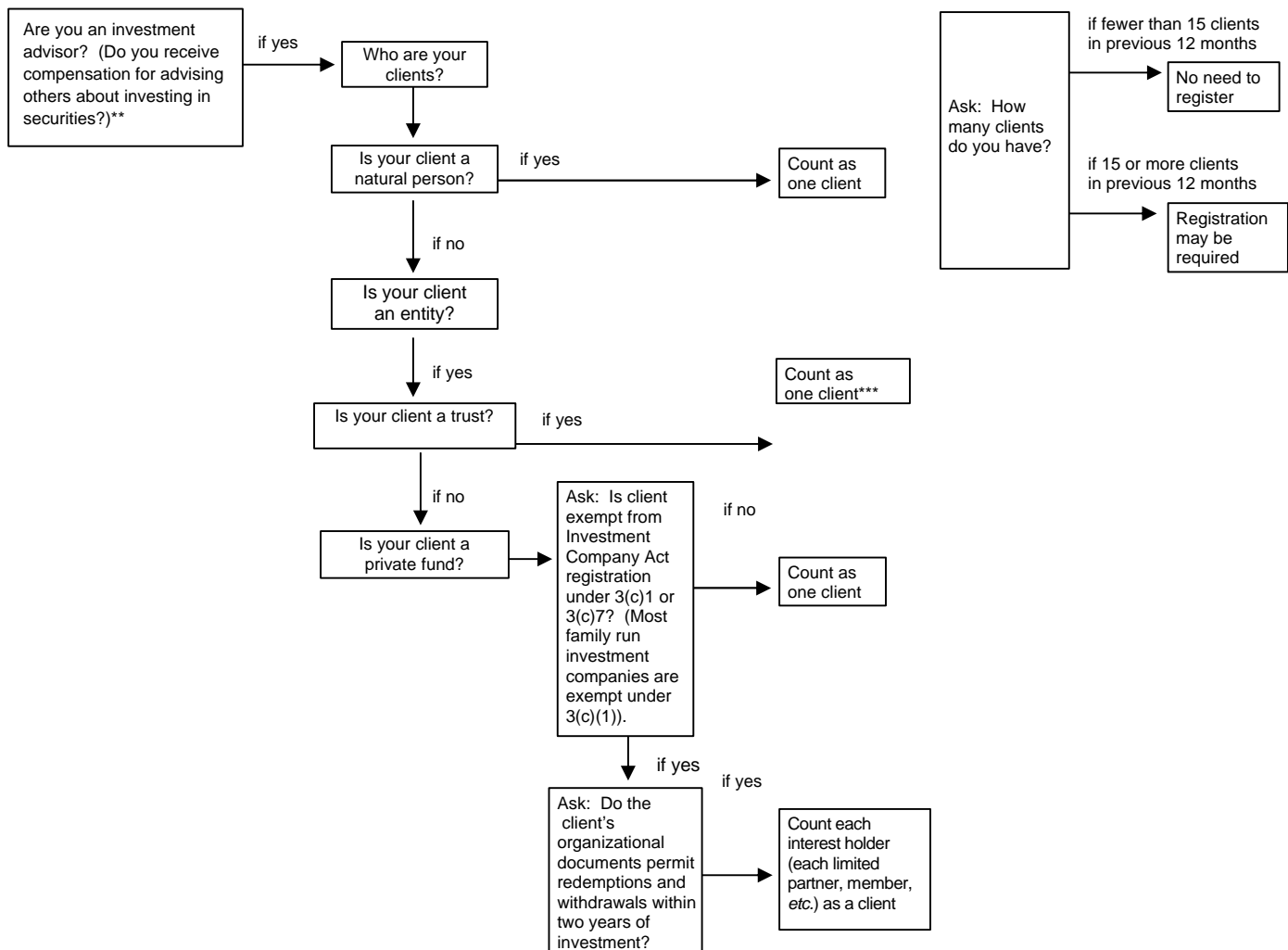
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Key Questions for Determining Whether an Adviser is Required to Register under the Investment Advisers Act of 1940*



* Please note that this overview has been prepared to assist in making a preliminary Investment Advisers Act of 1940 analysis, but should not be relied upon as legal advice.

** Note: Service as trustee to a trust may qualify as acting as an investment adviser to the trust.

*** In some circumstances, multiple trusts may be aggregated and treated as one client.