

SEC Comments on Hedge Fund Lock-Ups

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Paul Roye, director of the SEC's Division of Investment Management, recently stated that hedge funds which extend their lock-up periods (during which investors may not withdraw their capital from the fund) for two years to avoid registering as investment advisors may be a "red flag" for the SEC.

As we explained in a recent newsletter, investment partnerships with more than 14 private equity investors must ensure that the fund manager register as an investment advisor with the SEC by February, 2006. One of the exemptions to that requirement is if the fund has a lock-up period of two years.

Speaking at a Managed Funds Association Seminar, Roye stated, "Investors must ask themselves whether they are comfortable handing a multi-million dollar investment to an investment advisor that may be trying to avoid SEC registration." He went on to say that "it is our expectation that the market will therefore prevent circumvention of the rule."

Among the compliance provisions of the new SEC rules are:

- managers must develop compliance policies and procedures;
- a code of ethics; and
- designate a chief compliance officer.

By enacting these rules, the SEC hopes that funds will use these required compliance policies and procedures to perform a risk-based assessment on the operational aspects of each Fund's internal management to ensure that conflicts are managed and clients are protected. The SEC also has stated that small hedge funds, with five or fewer employees (and almost 70% have 10 or fewer employees) will not find these requirements overly costly or cumbersome.

The SEC is considering adopting rules that would require registration of those funds which go to a two year lock-up to avoid registration. The process to register requires the submission of a Form ADV. Most of the other requirements are internal steps. For instance, the Code of Ethics is not submitted for review. Rather, it is prepared internally and individualized for the Fund and is geared to an analysis of how the Fund will ensure that its investors are protected. For instance, when a Fund manager casts a vote on a Proxy, is he placing his investors' needs before his own?

Additionally, the new policies must ensure that the Chief Compliance Officer is involved in the day to day management and control of compliance regulations that effect the Fund. He must, among other things, ensure that document retention and accounting methods satisfy the new rules.

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