

Clients & Friends Memo

Registration of Hedge Fund Advisers

December 14, 2004

On December 2, 2004, the Securities and Exchange Commission (the "SEC") issued a release (IA-2333) containing new Rule 203(b)(3)-2 and amended related rules and Form ADV under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), that require certain hedge fund advisers to register with the SEC (collectively, the "New Rule"); the New Rule was published at 69 Fed. Reg. 72054 (December 10, 2004).

Pursuant to the New Rule, most "private fund" advisers will be required to register as investment advisers with the SEC. Generally, a "private fund" is an investment company that (i) is exempt from registration pursuant to Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended; (ii) permits its owners to redeem any portion of their ownership interests in the private fund within two years of the purchase of such interests; and (iii) offers interests in the fund based on the investment advisory skills, ability or expertise of the investment adviser. Registered investment advisers must comply with the rules and regulations of the Advisers Act, including, for example, regulations concerning performance fees, compliance procedures, recordkeeping requirements, and custody of client assets. The New Rule is not intended to apply to private equity funds, venture capital funds and certain other investment pools.

We have prepared the following to set forth some of the highlights of the New Rule, which we will supplement as the SEC and its staff provide additional clarification and guidance.

Registration

Private fund advisers with \$25 million or more in assets may register, and those with \$30 million or more in assets under management and 15 or more clients during the preceding 12 months will be required to register, with the SEC under the Advisers Act. Investment advisers will be permitted to

exclude from the \$30 million threshold knowledgeable advisory personnel who fall under the definition of “qualified clients,” as defined in Advisers Act Rule 205-3 (“Insiders”). Advisers may also exclude proprietary assets in their fund, as well as assets attributable to non-U.S. investors. Private fund advisers based outside the United States or in Wyoming (the only state that does not have an investment adviser registration requirement) with 15 or more “clients” will be required to register regardless of the amount of assets under management.

Counting Clients

The New Rule significantly changes the method by which “clients” will be counted. Currently, investment advisers count each fund advised by the adviser as a single client. Under the New Rule, however,

- investment advisers will have to “look-through” and count each owner of an interest or share in a private fund as a “client”;
- a hedge fund adviser whose investors include a fund of funds that is, itself, a “private fund” must “look-through” the “top-tier” fund and count each individual investor in each feeder fund as a “client.” In addition, an investment adviser must “look-through” any registered investment company that is directly or indirectly an investor; and
- subject to the following paragraph, hedge fund advisers located in offshore jurisdictions will have to “look-through” the funds they manage, regardless of whether those funds are located in an offshore jurisdiction, and generally will be required to count each investor that is a U.S. resident. A client’s residency status will be determined at the time such client invests in the fund and subsequent relocations will not change that status.

The SEC has noted that advisers to offshore publicly-offered mutual funds or closed-end funds should not be required to register under the Advisers Act merely because they have more than 14 investors residing in the U.S. The New Rule therefore excludes from the definition of “private fund” a fund that has its principal office and place of business outside the U.S., makes a public offering of

its securities outside the U.S., and is regulated as a public investment company under the laws of a country other than the U.S. As a result, this type of fund would count as a single non-U.S. client.

Finally, an investment adviser will be permitted to exclude itself and Insiders who invest in funds advised by such investment advisers when assessing whether it has 15 or more clients. Also, an investment adviser may deem the following to be a single client: a natural person, together with (i) such natural person's minor children, (ii) relatives, spouse or relatives of the spouse who have the same principal residence as the natural person, and (iii) all accounts and trusts of which the natural person and/or the persons referred to above are the only primary beneficiaries.

Extraterritorial Application

In keeping with its no-action letter dated July 28, 1992 to Uniao de Banco de Brasileiros S.A. (the "Unibanco Letter") and similar no-action letters issued by the SEC staff subsequent to the Unibanco Letter, the SEC has indicated that the New Rule has limited extraterritorial application. Under the New Rule, many of the substantive provisions of the Advisers Act, such as rules relating to compliance, code of ethics, performance fees, custody and proxy voting, would not apply to an offshore hedge fund adviser who is required to register in respect of its non-U.S. clients. However, offshore hedge fund advisers that are required to register must keep certain books and records and are subject to SEC inspections.

Lock-Up Period

To exclude the registration of investment advisers that manage only private equity funds, venture capital funds, and similar funds that require investors to make long-term commitments of capital, under the New Rule an investment fund will be considered a "private fund" only if it allows investors to redeem their investment within two years of the purchase of their investment. The New Rule provides an exception to the two year lock-up requirement by permitting redemptions under "extraordinary" circumstances. The SEC eliminated the proposed requirement that such circumstances be "unforeseeable." As examples of "extraordinary" circumstances, the SEC cited events that could cause the holding of the investment to become "impractical or illegal," the death or disability of an investor, the death of key investment advisory personnel, a merger or reorganization, or to avoid adverse tax or regulatory consequences.

The two year lock-up period requirement also distinguishes redemptions from distributions and permits a fund to make distributions in accordance with its governing documents without being a private fund. The New Rule also provides an exception to the two year lock-up period requirement for interests acquired through reinvestments of distributed capital gains or income, but the SEC noted that a fund cannot use “side letters” with individual investors to permit redemptions within two years.

Performance Fee

In general, under Advisers Act Rule 205-3, registered advisers are permitted to charge performance fees only to “qualified clients.” Thus, the New Rule effectively raises the eligibility standard of investors in private funds, who will be required to either have at least \$750,000 under management with the investment adviser, have a minimum net worth of \$1,500,000 or be an Insider. The New Rule, however, amends Rule 205-3 to apply prospectively so that investors already in a private fund (or who have a managed account with an investment adviser who is required to register) prior to February 10, 2005 will be grandfathered from having to comply with these requirements with respect to their existing investments or any additional investments by such investors into that private fund (or managed account).

Compliance Procedure/Chief Compliance Officer

Registered investment advisers will be required to develop comprehensive compliance procedures and designate a chief compliance officer. A registered adviser is required to designate a person internally that is primarily responsible for compliance, but is not necessarily required to hire new staff.

Custody Requirements

The New Rule amends Advisers Act Rule 206(4)-2, the custody rule, to extend from 120 to 180 days the time within which an investment adviser to a fund of hedge funds may deliver audited financial statements. This extended deadline applies to a fund of hedge funds that invests at least 10% of its assets in other, unrelated, pooled investment vehicles.

Recordkeeping Requirements

Pursuant to Advisers Act Rule 204-2, the recordkeeping rule, an adviser must retain all records and documentation relating to its performance track record for a period of five years after this information is used. The New Rule amends Rule 204-2 to allow a newly registered investment adviser to market the performance for all of its pre-existing “private funds,” as well as for all other accounts managed by the adviser prior to registration, even if they have not retained the required documentation. Investment advisers are required to maintain whatever supporting records they have as of the time of registration and, going forward, to comply with the Rule 204-2 recordkeeping responsibilities. The New Rule also clarifies that a registered investment adviser must maintain records not only for the funds for which it acts as an investment adviser, but also for those funds in which the investment adviser or a related person acts as a general partner, managing member, or in a similar capacity.

Form ADV

In order to register with the SEC, investment advisers are required to complete a Form ADV and file it with the SEC, and update it as necessary; firms currently registered with the SEC must file an amended Form ADV. As amended by the New Rule, Form ADV will require an adviser to a “private fund” to identify itself as a hedge fund adviser. The amended Form ADV also requires detailed disclosures of private fund activities, such as information about an investment adviser’s businesses, affiliates and owners, their disciplinary history, and disclosures about certain conflicts of interest.

Examinations and Inspections

Registered investment advisers are subject to on-site inspections and will be required to provide information upon request about their hedge fund activities and the individuals affiliated with them. The SEC intends to develop risk assessment tools to enhance the efficiency of its examination program so that the staff focuses examination resources on the areas of greatest risk to investors.

State Registration Requirements

You should note that the New Rule does not change investment adviser registration requirements under state laws. Accordingly, unregistered advisers with less than \$30 million in assets under management and their “investment adviser representatives” may still have to comply with applicable state registration requirements. However, the SEC has clarified that an investment adviser is not required to use the “look-through” approach of the New Rule for purposes of applying the “national de minimis standard” exempting advisers with fewer than 6 clients and no place of business in a given state from registration as an adviser in that state, nor are its supervised persons required to “look-through” for purposes of state “investment adviser representative” registration requirements.

Application of New Rule to CPOs and CTAs Registered with the CFTC

Commodity Pool Operators and Commodity Trading Advisors that are registered with the Commodity Futures Trading Commission (“CFTC”) and are members of the National Futures Association (the “NFA”) will be subject to the New Rule, regardless of the applicability of CFTC regulations and NFA oversight. However, an investment adviser who is registered as a commodity trading advisor, whose business does not consist of primarily acting as an investment adviser, and who does not act as an investment adviser to any registered investment company, remains exempt from registration as an investment adviser.

Validity of the New Rule

The SEC's legal authority to adopt the New Rule has been questioned and lawyers representing several hedge funds, as well as the United States Chamber of Commerce, advised the SEC that it is their view that the SEC does not have the legal authority to adopt the New Rule and that legal challenges may be made. In rebuffing these claims and adopting the New Rule, the SEC cited statutory language and the historical background of Section 203(b)(3)-2 and concluded that it has "broad authority to adopt the rule."

Planning For Registration

Although an investment adviser has until February 1, 2006 to register, by that date an investment adviser must have its registration effective, all of its policies and procedures in place, and a designated chief compliance officer. Accordingly, an investment adviser subject to SEC registration should begin the process of registration by taking the following preliminary steps: first, begin gathering information necessary for completing the Form ADV; second, identify and designate a chief compliance officer, which may require the hiring of additional personnel or providing supplemental training to existing personnel; and third, review existing compliance policies and procedures and begin drafting a comprehensive set of policies and procedures designed to prevent violations of the Advisers Act.

Conclusion

It is anticipated that as the SEC staff sorts through the ambiguities and difficulties resulting from the New Rule, it will issue a series of interpretative letters. We will continue to monitor developments as they arise and keep you informed about the New Rule. If you have any questions as to how the New Rule is likely to affect your business, please contact any of the following attorneys:

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