SECURITIES AND EXCHANGE COMMISSION REQUIRES HEDGE FUND ADVISERS TO REGISTER BY FEBRUARY 1, 2006

Introduction

The Securities and Exchange Commission (the "Commission") last week published the text of the new Rule 203(b)(3)-2 (the "New Rule") and amendments to existing rules, adopted on October 26, 2004, which will require advisers to certain private investment pools, such as hedge funds, to register with the Commission under the Investment Advisers Act of 1940 (the "Advisers Act") by February 1, 2006. In effect, however, the new registration provision will apply only to advisers whose hedge funds accept new money on or after February 1, 2006, from new investors or from those already in the fund, and then, only if the new money is not subject thereafter to a two-year lock up, described below.

The Commission release published with the New Rule and the amendments (the "Release")[1] clarifies some of the issues raised by the New Rule and amendments, including those concerning:

- counting investors in private funds as clients;
- operation of the exemption from the "look through" requirement for private funds with a two-year lock-up;
- treatment of offshore advisers and funds; and
- application of revisions to the recordkeeping, custody and performance fee rules.

The Release also includes a dissent by Commissioners Glassman and Atkins, who voted against adoption of the New Rule. A copy of the Release is available on the Commission's website at www.sec.gov/rules/final.shtml.

Effective Dates/Compliance Date

The effective date of the New Rule and most of the amendments is February 10, 2005.[2] Advisers will have until February 1, 2006, however, to register and be in compliance with the New Rule.

---

[1] "Registration Under the Advisers Act of Certain Hedge Fund Advisers," SEC Release IA-2333 (December 2, 2004).

[2] As described below, the amendments to Rule 206(4)-2, are effective January 10, 2005. Certain "grandfathering" amendments are not available for advisers registered before the effective date.

The Current Rule

Section 203(b)(3) of the Advisers Act exempts from registration investment advisers that during the preceding 12-month period have had fewer than 15 clients and that meet certain other conditions. Before the effectiveness of the New Rule, Rule 203(b)(3)-1 under the Advisers Act provides, among other things, that a legal organization (such as a private investment fund) that receives investment advice based on its investment objectives and not the individual investment objectives of its owners is treated as a single client. Under that rule, private investment fund managers that comply with the other terms of Section 203(b)(3) have been permitted to advise up to 14 private funds in any 12-month period without registering under the Advisers Act.[3]

The New Look Through for Private Funds

The New Rule overturns past practice and will require investment advisers to "look through" a "private fund" and count each owner of the private fund as a client for purposes of determining whether they meet the 14-client exemption. The New Rule defines a private fund as a company: (i) that would be an investment company under Section 3(a) of the Investment Company Act of 1940, as amended, (the "Investment Company Act") but for the exception provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act,[4] (ii) that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests, and (iii) in which interests have been offered based on the investment advisory skills, ability or expertise of the investment adviser.

The exemption for advisers having 14 or fewer clients requires that the adviser count all persons who have been clients at any time during the preceding 12 months. The Commission will apply the new look-through counting rule only prospectively, without regard to this "look back" provision for the period leading up to the February 1, 2006 compliance date.[5] As a result, an adviser will need to look through a private fund only on or after February 1, 2006 to determine whether registration is required.

---

[3] The investment adviser regulations of certain states do not contain a similar *de minimis* exemption. Accordingly, depending on where its place of business is located, a private investment fund adviser may already be subject to investment adviser registration under state law. The state regulators may modify their rules to adopt "look through" provisions similar to the New Rule.

[4] Section 3(c)(1) exempts from registration any issuer the outstanding securities of which are beneficially owned by not more than 100 persons and that does not make a public offering of its securities. Section 3(c)(7) exempts from registration any issuer the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers," and that does not make a public offering of such securities. Private investment funds, including hedge funds, private equity funds and venture capital funds, generally rely on one of these exemptions.

[5] Release Section III, n. 273.

The Two-Year "Lock-Up"

The New Rule provides that a fund that does not permit redemptions of interests within two years of purchase is not a private fund for purposes of the look-through provision.[6] In effect, however, the registration provision in the New Rule will apply only to advisers whose hedge funds accept new money from new investors or from those already in the fund, on or after February 1, 2006 and then, only if the new money is not subject thereafter to a two-year lock-up.[7]

The two-year redemption test must be applied separately to each interest purchased or amount of capital contributed by an investor in the fund, not just to the investor's initial investment, but it does not apply to the reinvestment of distributed capital gains or income.[8] The New Rule will require the lock-up to begin anew if an investor is permitted to exchange its interest in one fund for an interest in another fund managed by the same adviser. Funds with a two-year lock-up may nonetheless permit redemptions within two years of purchase in the case of events that the adviser finds after reasonable inquiry to be extraordinary. The Commission indicated that such extraordinary events would be deemed to have occurred if: (i) continuing to hold the investment becomes "impractical or illegal," (ii) the owner dies or becomes totally disabled, (iii) key personnel at the fund adviser die, become incapacitated, or cease to be involved in the management of the fund for an extended period of time, (iv) the fund merges with another entity or is reorganized, or (v) redemption is necessary to avoid a materially adverse tax or regulatory outcome, including the need to avoid the fund assets from being considered "plan assets" for purposes of the Employee Retirement Income Security Act of 1974.[9]

Offshore Advisers

Offshore advisers will be subject to the same look-through requirements as domestic advisers in the New Rule if they have more than 14 investors in a private fund or other advisory clients that are U.S. residents. Thus, many offshore advisers to offshore hedge funds will need to register as investment advisers under the Advisers Act unless, for example, they avail themselves of the

---

6 In the Release, Section II.E.2., the Commission notes that the exemption from the definition of private fund for funds not permitting redemptions within two years of purchase is designed to exclude advisers to venture capital and private equity funds from the proposed registration requirements. This exemption is based, the Commission stated, on the fact that the Commission has not encountered significant enforcement problems with advisers with respect to their management of these types of funds.

7 Release, Section III.

8 The two-year test may be applied to accounts of investors on a "first in, first out" basis. Release Section II.E.2., and n. 231.

9 Release at n. 240. The Commission deleted a proposed requirement that extraordinary events be "unforeseen."

lock-up provision discussed above. These look-through requirements will not apply to offshore advisers to public funds that make public offerings of their securities in a country other than the United States and are regulated as public investment companies under the laws of a country other than the United States. These funds are excluded from the definition of "private funds."[10]

The Commission provided guidance as to what constitutes a U.S. "resident." The Commission stated in the Release that it will not object if advisers look: (i) in the case of individuals, to their residence, (ii) in the case of corporations and other business entities, to their principal office and place of business, (iii) in the case of personal trusts and estates, to a rule set out in Regulation S under the Securities Act of 1933, and (iv) in the case of discretionary or non-discretionary accounts managed by another investment adviser, to the location of the person for whose benefit the account is held.[11] The determination of whether a client is a U.S. resident is made at the time of the client's investment in the offshore private fund.[12]

The $25 million minimum asset-under-management threshold for registering as an investment adviser under the Advisers Act will not apply to offshore advisers. As a result, any offshore adviser that has more than 14 clients resident in the United States during the preceding twelve months must register with the Commission as an adviser irrespective of the amount of assets it has under management.[13]

Offshore advisers to offshore hedge funds will be permitted to treat the hedge funds, and not the investors in such funds, as their clients for all purposes of the Advisers Act other than the 14-client exemption and certain anti-fraud provisions, provided that (i) the adviser has its principal office and place of business outside the United States, and (ii) the fund is organized or incorporated under the laws of any jurisdiction other than the United States. Consequently, if an offshore adviser meets these requirements it will not be subject to Rule 206(4)-2 (the "Custody

---

10 The Commission did not clarify what constitutes a public investment company regulated under the laws of another jurisdiction, but noted that in some jurisdictions hedge funds may be publicly offered, which will require a case-by-case determination as to whether the fund is in fact a "public investment company." The Commission also did not clarify whether the determination of whether a "public offering" exists would be made by reference to U.S. law or the law of another jurisdiction.

11 Release Section II.D.4.a. at n. 201. The Commission did not provide further clarification as to how to treat foreign subsidiaries of U.S. corporations.

12 Rule 203(b)(3)-1(b)(7). It appears from the language of the New Rule that advisers relying on the offshore adviser exception will need to make the determination each time an investor adds to its investment in the offshore fund. The Commission did not provide guidance on whether the adviser needs to continue to make the residence determination for reinvestment of capital gains and income.

13 A domestic adviser may exclude assets under management attributable to non-resident investors for the purposes of determining whether the adviser meets the $25 million threshold to register with the Commission.

Rule"), Rule 206(4)-6, the proxy voting rule, or Rule 206(4)-7, which requires compliance procedures and designation of a compliance officer.[14] Registered offshore advisers will be subject to Commission inspection, and the Commission stated that inspection would include "all records of any registered adviser."[15] In addition, offshore advisers required to be registered under the Advisers Act will have to keep certain books and records.[16] The Commission is continuing to follow the staff's prior no-action letters concerning the application of the Advisers Act to non-U.S. clients of offshore advisers.[17]

Funds of Funds Investors

The New Rule requires advisers to hedge funds to look through any "top-tier" funds, registered or unregistered, that invest in the hedge fund, in determining whether the adviser has more than 14 clients.[18]

Registered Investment Companies as Hedge Fund Investors

Rule 203(b)(3)-2(b) requires advisers to private funds to look through any registered investment company owning interests in the hedge fund to count the investors in the registered investment company as clients of the adviser. Because registered investment companies have more than 14

---

[14] In the proposing release, IA-2266, (July 20, 2004), the Commission indicated that U.S. advisers will not be permitted to establish a non-U.S. shell subsidiary to manage offshore hedge funds, as that would violate Section 208(d) of the Advisers Act, which prohibits any person from doing indirectly anything that would be unlawful for such person to do directly. Advisers with no affiliates, employees or other physical presence in the United States would presumably be able to rely on the exemption for offshore advisers. It may be difficult, however, to apply this exemption to advisers with more than a nominal presence in the United States.

[15] Release at n. 217.

[16] The Commission cited prior no-action relief concerning recordkeeping obligations of registered advisers that are located offshore. Under that series of no-action letters, the Commission staff has permitted certain exceptions from recordkeeping requirements under the Advisers Act. See, e.g. *Royal Bank of Canada*, SEC staff no-action letter (June 3, 1998).

[17] See, e.g., *União de Banco de Brasileiros S.A.*, SEC staff no-action letter (July 28, 1992) and *ABN AMRO Bank, N.V.*, SEC staff no-action letter (July 1, 1997). Under these no-action letters, the Commission staff has set forth exceptions to certain requirements for registered foreign advisers who have U.S. clients, particularly with respect to their non-U.S. clients, based on certain conditions (including the adviser not holding itself to non-U.S. clients as being registered under the Advisers Act).

[18] The New Rule does not require the adviser to the underlying fund to receive information as to the precise number or identities of the top-tier investors other than that the top-tier fund has more than 14 owners. See the Release Section II.D.3., n. 196.

investors, the practical implication of this provision will be to require registration of advisers to hedge funds that permit registered investment companies to own their shares.[19]

Limited Relief Permitting Continued Advertising of "Track Records"

Under Rule 204-2(e)(3), a registered adviser that makes claims concerning its performance must maintain documentation supporting those performance claims. Such records must be retained for a period of five years after the performance information is last used. A hedge fund adviser will continue to be able to use performance information for periods prior to its registration even if the adviser has not retained the necessary supporting information as required by Rule 204-2. The adviser will, however, be required to retain whatever records it does have — *i.e.*, the recordkeeping requirement will apply to records in the adviser's possession as of February 10, 2005. In response to comments, this exemption has been expanded to apply to the performance history of any account managed by an adviser to a private fund and not just the performance of the private fund. As noted above, the relief covers records made during the period before February 10, 2005. So on and after that date the proper records must be kept, even if the adviser registers closer to the February 1, 2006 compliance date. This relief is available only to advisers to private funds that register after the February 10, 2005 effective date, and not to advisers that voluntarily register before that date.

The recordkeeping rule has also been amended to specify that, for purposes of Section 204 of the Advisers Act, the books and records of an adviser include the records of any private funds for which such adviser acts as general partner, managing member or in any similar capacity.

Limited Relief from Prohibition on Performance Fees

Registered investment advisers are generally prohibited from charging a performance fee to clients who are not "qualified clients." Generally, qualified clients are investors, either individuals or companies, that invest at least $750,000 with an investment adviser or that have a net worth of $1.5 million. The amendments "grandfather" from this requirement investors in a private fund that were investors before February 10, 2005, provided that the adviser was not required to register with the Commission. Without this exemption, investors that are not qualified clients would need to withdraw from the investment fund before the adviser registered under the Advisers Act, or else the adviser would need to forego charging those investors a

---

[19] As mentioned in note 18 above, the Commission noted in the Release, at n. 196, that the underlying hedge fund need not "receive information as to the identities" of the registered fund's investors. The hedge fund adviser must determine, on a periodic basis, whether the registered investment company has sufficient ownership to cause the adviser to need to register with the Commission. This provision may be particularly burdensome for foreign advisers who have registered investment company investors in a foreign, unregistered fund pursuant to *The France Growth Fund* no-action letter (July 15, 2003), as they may not normally apply U.S. look-through rules.

performance fee.[20] Grandfathered investors will be permitted to add to their accounts, but not to open new investment accounts in the hedge fund or in other hedge funds managed by the same adviser. This relief is available only to advisers that register after February 10, 2005, the effective date of the New Rule; it is not available to advisers that voluntarily register before that date.

Expansion of an Exemption in the Custody Rule

An exemption available to pooled investment vehicles under the Custody Rule has also been modified to provide additional relief to funds of funds. Currently, advisers to pooled investment vehicles (such as private funds) are not required to comply with the surprise audit and reporting requirements of the Custody Rule if they distribute audited financial statements prepared in accordance with generally accepted accounting principles to all fund investors within 120 days of the end of the investment vehicle's fiscal year. As amended, effective January 10, 2005, the Custody Rule will extend the required delivery date to no later than 180 days after the end of the fiscal year for any "fund of funds". A fund of funds is defined as any pooled investment vehicle that invests at least 10% of its total assets in other pooled investment vehicles that are not related persons to the fund of funds, its adviser or general partner. This change is designed principally for funds of funds since such funds often are unable to meet the 120-day deadline because they cannot complete their financial statements until they receive financial statements from all the funds in which they were invested during the preceding year.[21]

State Registration Requirements

The New Rule and amendments do not alter the minimum assets under management required to register with the Commission. Accordingly, advisers with less than $25 million under management will continue to be ineligible for Commission registration (except offshore advisers, as described above). Such advisers may be required to register under applicable state law.[22] Advisers with between $25 and $30 million in assets under management are eligible to register voluntarily with the Commission.

---

20 Private investment funds exempted from investment company registration pursuant to Section 3(c)(7) of the Investment Company Act are not subject to the restriction on performance fees.

21 Amended Rule 206(4)-2(c)(4) looks to the definition of "Related Person" found in Form ADV for purposes of the "fund of funds" definition. In the Release, the Commission stated that the relief did not extend to funds that are not "funds of funds" because such funds might then take 180 days to complete their audits. Thus, funds of funds investing in such underlying funds would face the same timing problem in completing their own audits.

22 Investment advisers located in states with a *de minimis* exemption from investment adviser registration may be able to continue to rely on such exemption. While such states may follow the Commission's lead and adopt a similar "look through" rule, there may be a significant time-lag until that occurs.

As originally proposed, the New Rule and amendments would have had an apparently unintended effect on the availability of the exemption for employees of federally registered advisers from state registration. The Commission, acknowledging the comments received concerning these unintended results, revised Rules 222-2 and 203A-3 to clarify that advisers and Supervised Persons of advisers should for the purposes of those rules count clients as provided in Rule 203(b)(3)-1 without applying the look-through provisions of New Rule 203(b)(3)-2. [23]

Form ADV

The Commission has modified Form ADV Part 1A Item 7.B. and Schedule D Section 7.B. to require disclosure of status as an adviser to a "private fund", as defined in Rule 203(b)(3)-1.[24] The modification will be incorporated in the IARD electronic filing system Form ADV for registered investment advisers on March 8, 2005, and all registered advisers filing amendments to Form ADV after the form incorporates these changes must respond to the questions on the form, as amended, and in any event do so by the compliance date February 1, 2006.

Suggested Action

Unregistered advisers to private investment funds who are currently exempt from registration under Section 203(b)(3) of the Advisers Act should assess whether they will be required to register with the Commission. If registration is required, preparation should begin as soon as possible to assure timely compliance with all applicable Commission rules.[25]

* * * * * * * * * * * * * * *

---

[23] Under the New Rule as originally proposed, officers and employees of advisers firms becoming subject to registration with the Commission in many cases would also have become subject individually to registration with the states. In most states, registration of individuals includes testing and other state compliance requirements. In addition, the Commission has modified the rule amendments to preserve the federal preemption of state law which limits the power of the states to require registration of out-of-state advisers not registered with the Commission.

[24] The Commission stated in the Release, Section II.K. at n. 271 that mere identification of a private fund through the Commission's electronic Investment Adviser Public Disclosure system, the IAPD, does not render the private placement exemption under Securities Act Section 4(2) or Rule 506 unavailable.

[25] Upon registration, the adviser will be subject to numerous Commission rules including: (i) the requirement to create, file and keep current Form ADV, (ii) the recordkeeping requirements of Rule 204-2, (iii) the performance fee requirements of Rule 205-3, (iv) the custody requirements of Rule 206(4)-2, (v) the solicitor requirements of Rule 206(4)-3, (vi) the proxy voting requirements of Rule 206(4)-6, (vii) the requirement to designate a compliance officer and adopt compliance procedures of Rule 206(4)-7, and (viii) the requirement to have a Code of Ethics found in Rule 204A-1, among others. In addition, although advisers to private funds will have until February 1, 2006 to become registered, advisers must keep performance records in compliance with the existing rules on and after February 10, 2005.

If you have any questions regarding this memorandum, please contact Roger D. Blanc at (212) 728-8206, Rose F. DiMartino at (212) 728-8215, Burton M. Leibert at (212) 728-8238, Daniel Schloendorn at (212) 728-8265, Emily M. Zeigler at (212) 728-8284, Benjamin J. Haskin at (202) 303-1124, Martin R. Miller at (212) 728-8690, Rita M. Molesworth at (212) 728-8727 or Joseph Bergman at (212) 728-8173.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office at 1875 K Street, N.W., Washington, DC 20006-1238. Our main telephone number is (212) 728-8000, and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

December 10, 2004