COMMISSION RESPONDS TO QUESTIONS ON HEDGE FUND ADVISER REGISTRATION

I. Introduction

In 2004, the Securities and Exchange Commission (the "Commission") adopted Rule 203(b)(3)-2 and related rule amendments (the "New Rule") that require advisers to certain privately offered investment funds to register under the Investment Advisers Act of 1940 (the "Advisers Act"). On December 8, 2005 the Commission's Division of Investment Management responded to the questions concerning the New Rule posed in a June 23, 2005 letter from the ABA Subcommittee on Private Investment Entities (the "Response").[1]

The Response discusses, among other topics, the circumstances in which an adviser must count investors in a private fund as clients, the treatment of related entities and sub-advisers, filing deadlines and recordkeeping by fund administrators.

IMPORTANT NOTE: on December 9, 2005, the United States Court of Appeals for the District of Columbia Circuit heard oral argument in *Goldstein v. U.S. Securities & Exch. Comm'n,* a case in which the SEC's New Rule is being challenged as exceeding the SEC's statutory authority under the Advisers Act. The court has not issued a decision in that case, but the press reports indicate two of the three judges who heard the case at oral argument expressed skepticism at the SEC's rationale for the New Rule and its authority to adopt it. Unless and until the court acts to invalidate the New Rule, however, it remains scheduled to come into full force and effect on February 1, 2006.

II. Background

The Advisers Act exempts advisers from registration if they meet certain requirements, including having not more than 14 clients in any twelve-month period. For many years, a hedge fund and not its underlying investors was considered the "client" for purposes of the 14 or fewer exemption. The New Rule reverses that policy and provides that an investment adviser must "look through" any "private fund" to count the fund's investors as clients.

---

[1] The Division's Response can be found at http://www.sec.gov/divisions/investment/noaction/aba120805.htm.

The New Rule defines a "private fund" as a company: (1) that would be an investment company under section 3(a) of the Investment Company Act of 1940 (the "Investment Company Act") but for the exception provided from that definition by either section 3(c)(1) or section 3(c)(7); (2) that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and (3) interests in which are or have been offered on the basis of the investment advisory skills, ability or expertise of the investment adviser.

III. Discussion Items

The Response covered a number of specific questions posed in the ABA letter including the following:

A. Two-Year Lock-up

- If an owner of a fund, otherwise within the definition of "private fund" as described above, is permitted to redeem *before* the second anniversary of the date of investment, the fund is a "private fund" under the New Rule. As interpreted by the SEC staff, this requires twenty-four months and one day. For example, a fund would not be a "private fund" if it did not allow an owner that purchases an ownership interest on January 1, 2007 to redeem until January 1, 2009. A fund which allows such an interest to be redeemed on or before December 31, 2008 would not satisfy the two-year lock-up requirement.

- A fund that allows non-U.S. investors to redeem their ownership interests within two years of purchase falls within the definition of a private fund.

- The two-year lock-up must apply to advisers, general partners, knowledgeable employees as well as to other owners of the fund. The SEC rejected the suggestion that the lock-up should not apply to fund insiders.

- For purposes of the New Rule, deferred incentive fees and accrued incentive allocations are compensation for services provided by the adviser and the general partner and the two-year lock-up does not apply to such fees or allocations.

- A transfer from one class of an interest in a fund to another class will not be considered a redemption under the New Rule where the two classes share the same underlying portfolio of investment securities and provide investors with the same redemption rights.

- No redemption would be involved where an investor moved from one feeder fund that invests all of its assets solely in a master fund to another feeder fund that also invests all of its assets solely in the same master fund and offers its investors the same redemption rights. The two-year holding period for the investment would run from the date of the purchase of the interest in the original class.

- A captive master-feeder structure[2] is viewed as an integrated structure, such that the adviser could look only to whether the investors in the feeder funds are permitted to redeem any portion of their interests in the feeder funds within two years of their purchase for purposes of the definition of "private fund" in the New Rule.

- The dissolution or liquidation of an owner may be considered an extraordinary event and an exception to the two-year lock-up requirement[3] where the entity ceases to operate and the adviser has a reasonable basis to believe that the entity owner's dissolution or liquidation is bona fide and not designed to avoid the two-year lock-up period.

- A significant withdrawal of investment by an adviser is an event within the adviser's discretion and would not be viewed as an "extraordinary event." Therefore, a fund in which investors have redemption rights that would be triggered in the event of a significant withdrawal by the adviser or its personnel would meet the definition of "private fund."

- For purposes of the two-year lock-up, gains or income allocated to an investor's capital account, and any subsequent appreciation thereon, should be assigned the date of the investor's original investment to which those allocated gains or income are attributable.

- The original purchase date may be attributed to an interest in a fund transferred in a secondary market transaction, including interests transferred without consideration (i.e., gifts), provided the transaction was not arranged or initiated by the adviser or fund manager, and there has been no arrangement between the fund and either investor to circumvent the two-year lock-up provision in the definition of "private fund."

B. Registration of Sub-advisers to "Private Funds"

- If a fund is a "private fund," it is a "private fund" with respect to all its advisers, including subadvisers that manage a portion of the private fund's assets, with or without investment discretion.

- An offshore subadviser, however, will not be required to register with the Commission as an investment adviser solely because it advises a private fund, provided: (1) the

---

[2] Such a structure would consist of multiple master and multiple feeder funds where the same adviser would (a) purchase and sell investment securities only at the master funds level and (b) reallocate, from time to time, the feeder funds' assets exclusively among the master funds. Only the feeder funds would be permitted to invest in the master funds. The reallocations would affect only the composition of the portfolio of the feeder fund, and not the ownership interests of investors in the feeder fund.

[3] Amended Rule 203(b)(3)-1(d)(2)(i) provides that a fund will not be deemed a "private fund" if the fund permits investors to redeem their interests within two years of the purchase of such interests in the case of events that the adviser finds after reasonable inquiry to be extraordinary.

subadviser is hired (and subject to being discharged) by the private fund's adviser that is registered with the Commission ("primary adviser"); (2) the subadviser is not otherwise required to register with the Commission; (3) the subadviser does not control, is not controlled by, and is not under common control with the fund's primary adviser; (4) the written materials provided to the fund's investors clearly disclose that a portion of the fund's assets may be managed by one or more offshore subadvisers that are not registered with the Commission; and (5) at the time the subadviser is hired, and at the time any additional assets of the fund are allocated to the subadviser for management, the unregistered offshore subadviser does not manage more than 10 percent of the fund's total assets.

C. Registration of Related Entities

- A special purpose vehicle ("SPV") established by a registered investment adviser to act as the private fund's general partner or managing member will not have to register separately as an investment adviser with the Commission provided: (1) the SPV has no employees or other persons acting on its behalf other than officers, directors, partners or employees of the adviser; (2) all the investment advisory activities of the SPV are subject to the Advisers Act and the rules thereunder; (3) the SPV is subject to examination by the Commission; and (4) the SPV, its employees and persons acting on its behalf are subject to the adviser's supervision and control.

- Non-U.S. advisory affiliates of a registered adviser need not separately register as long as the non-U.S. affiliates comply with existing Commission no-action letters.[4]

D. Family Offices and Family Funds

- If interests in a family investment fund are not offered on the basis of the investment advisory skills, ability or expertise of the adviser, the fund is not a private fund under the New Rule. Whether a fund is offered on the basis of its adviser's expertise is determined by the facts and circumstances of that particular fund. Neither the fact that the fund is offered only to family members, nor the fact that a family member controls the adviser, necessarily determines whether the investors are committing their capital to the fund on the basis of the adviser's expertise.

---

[4] Those letters include Uniaos de Banco de Brasileiros S.A., SEC Staff Letter (July 28, 1992); Mercury Asset Management plc, SEC Staff Letter (Apr. 16, 1993); Kleinwort Benson Investment Management Limited, et al., SEC Staff Letter (Dec. 15, 1993); Murray Johnstone Holdings Limited, et al., SEC Staff Letter (Oct. 7, 1994); ABN AMRO Bank N.V., et al., SEC Staff Letter (July 1, 1997), and Royal Bank of Canada, et al., SEC Staff Letter (June 3, 1998).

E. Filing Deadline

- Advisers that will be required to register as a result of the New Rule are urged to submit their applications no later than December 15, 2005 (to be sure that there are at least 45 days before the compliance date of February 1, 2006).

- Since the Response was not published until December 8, 2005 however, the staff stated that if an adviser required to register as a result of the Commission's adoption of the New Rule files its initial application for registration as an investment adviser on Form ADV with the Commission not later than January 9, 2006, the staff will endeavor to act upon the application by February 1, 2006.

F. Principal Transactions and Rebalancing

- The staff did not further clarify whether the notice and consent requirements of section 206(3) of the Advisers Act apply to periodic rebalancing transactions, or to transactions between an adviser's client and an unregistered pooled investment vehicle in which the adviser and/or its personnel have an ownership interest and merely stated that the analysis depends upon all of the facts and circumstances.

G. Form ADV

- The staff confirmed that Section 7.B of Schedule D of Form ADV requires an adviser to a master-feeder structure to report both the feeder funds and the master fund, and to identify the current value of the total assets in each.

H. The Custody Rule

- An offshore prime broker is eligible to act as a qualified custodian pursuant to Rule 206(4)-2 (the "Custody Rule") if it maintains either a separate account for each advisory client under the client's name (section 206(4)-2(a)(i)) or a separate account for the assets of the adviser's clients under the adviser's name as agent or trustee for the clients (section 206(4)-2(a)(ii)) and also keeps advisory clients' assets in customer accounts segregated from the institution's proprietary assets.

- The staff declined to grant an exemption from the GAAP requirement for audited financials[5] for an audit that is not compliant with GAAP because an unregistered pooled investment vehicle amortized its start-up costs so that those costs are not borne solely by the initial investors.

---

[5] Advisers with custody are not required to have the custodian send quarterly account statements to all investors in a fund if the fund is audited annually and its financial statements are prepared in accordance with GAAP and copies of the audited financials are forwarded to investors.

I. Record Retention

- The New Rule amended the Advisers Act recordkeeping Rule 204-2 to provide that the books and records of a private fund are considered records of the adviser for purposes of the rule if the adviser or a related person acts as the fund's general partner, managing member or in a comparable capacity. Rule 204-2 generally requires that an adviser's records be maintained in the adviser's principal office. A fund's administrator may maintain the records for the fund at its offices, provided that: (1) the administrator acts as a service provider to the adviser in maintaining, preparing, organizing and/or updating the adviser's records for the adviser's ongoing use in its business, and does not merely provide long-term storage of the records; and (2) upon request of the Commission's staff, the records are produced promptly for the staff at the appropriate office of the adviser or an office of the administrator.

- If neither the adviser nor any of its related persons act as a private fund's general partner, managing member, or in a similar capacity, as is the case with many funds organized offshore, the books and records of the private fund will not be considered to be records of the adviser.

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

If you have any questions concerning this memorandum, please contact Roger D. Blanc (212-728-8206, rblanc@willkie.com), Rose F. DiMartino (212-728-8215, rdimartino@willkie.com), Burton M. Leibert (212-728-8238, bleibert@willkie.com), Daniel Schloendorn (212-728-8265, dschloendorn@willkie.com), Emily M. Zeigler (212-728-8248, ezeigler@willkie.com), Benjamin J. Haskin (202-303-1124, bhaskin@willkie.com), Martin R. Miller (212-728-8690, mmiller@willkie.com), Rita M. Molesworth (212-728-8727, rmolesworth@willkie.com) or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office at 1875 K Street, NW, Washington, D.C. 20006-1238. Our New York telephone number is 212-728-8000 and our facsimile number is 212-728-8111. Our Washington, D.C. telephone number is 202-303-1000 and the facsimile number is 202-303-2000. Our website is located at www.willkie.com.

December 15, 2005