ARNOLD & PORTER LLP

CLIENT ADVISORY

SEC Provides No-Action Relief for Registered Investment Advisers

On August 10, 2006, the SEC issued a No-Action Letter in response to the no-action relief request from the American Bar Association ("ABA") requesting that the SEC issue "emergency" procedures in light of the recent decision by the U.S. Court of Appeals for the D.C. Circuit in *Goldstein v. SEC*, striking down the SEC's hedge fund adviser registration rule.

In the No-Action Letter, the SEC provided guidance on the SEC's Division of Investment Management's position on enforcement relating to investment advisers that remain registered, investment advisers that withdraw their registrations and various other matters. Most of the matters addressed in the No-Action Letter were previously announced in the testimony of SEC Chairman Cox before the Senate Banking Committee last month. Please see our Client Advisory distributed on July 27, 2006, for more information related to Chairman Cox's testimony.

INVESTMENT ADVISERS THAT REMAIN REGISTERED

Offshore Investment Advisers to Offshore Funds

The SEC noted that, under principles set forth in prior SEC guidance and letters, the substantive provisions of the Investment Advisers Act of 1940, as amended, do not apply to offshore investment advisers with respect to such advisers' dealings with offshore funds and other offshore clients to the extent described in such letters and the hedge fund adviser registration rule Adopting Release. However, a registered offshore adviser must comply with all of the Investment Advisers Act and the rules promulgated thereunder with respect to any U.S. clients (and prospective U.S. clients) it may have.

Records Supporting Performance Information

In connection with the adoption of the hedge fund adviser registration rule, the SEC amended Rule 204-2 (which requires the retention of certain records that "form the basis for or demonstrate the calculation of the performance or rate of return") to create a limited "transition" exception for hedge fund advisers. Under such exception, certain advisers were not required to maintain books and

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records meeting the requirements of Rule 204-2(a)(16) to support the performance of any private fund or other account for any period ended prior to February 10, 2005. In the No-Action Letter, the SEC affirmed that the SEC staff will not recommend enforcement action if a hedge fund manager that registered as an investment adviser under the hedge fund adviser registration rule does not maintain or preserve such books and records, provided that the adviser meets the terms and conditions of the transition exception.

Performance-Based Compensation Arrangements

Under the hedge fund adviser registration rule, the SEC had amended Rule 205-3 (which allows a registered investment adviser to receive performance-based compensation with respect to "qualified clients") to allow hedge fund managers that registered as investment advisers as a result of the hedge fund adviser registration rule to continue receiving performance-based compensation from private funds with non-qualified investors and from other clients who are not "qualified clients" if such persons became equity investors in the private fund or entered into investment advisory contracts with the adviser before February 10, 2005. The No-Action Letter states that the SEC staff will not recommend enforcement action to the SEC against a hedge fund adviser that receives such performance-based compensation if and to the extent that the adviser would have been exempt from the prohibition on receiving such compensation under the now-vacated hedge fund adviser registration rule.

Custody Rule

The SEC had extended the deadline for delivering audited financial statements of a "fund of funds"[1] from one hundred twenty (120) days to one hundred eighty (180) days following the end of the fund of fund's fiscal year. The No-Action Letter provides that the SEC staff will not recommend enforcement action to the SEC against an adviser to a fund of funds relying on the "annual audit exception" if the audited financial statements of the fund of funds are distributed to investors within one hundred eighty (180) days of the fund of funds' fiscal year end.

1 Under the hedge fund adviser registration rule, a "fund of funds" was defined as a "limited partnership (or limited liability company, or another type of pooled investment vehicle) that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person (as defined in Form ADV (17 CFR 279.1)), of the limited partnership, its general partner, or its adviser."

INVESTMENT ADVISERS THAT WITHDRAW THEIR REGISTRATIONS

Continued Availability of Section 203(b)(3)

Before registering with the SEC, many hedge fund managers relied on Section 203(b)(3) of the Investment Advisers Act which provides an exemption from registration for any adviser who, during the course of the preceding twelve (12) months, has had fewer than fifteen (15) clients and who does not hold himself out generally to the public as an investment adviser. During the period it was registered as an investment adviser, a hedge fund manager may have held itself out to the general public as an investment adviser or taken on additional clients so that it has more than fourteen (14) clients (counting each private fund as a single client). The No-Action Letter affirms that the SEC staff will not recommend enforcement action to the SEC under Section 203(a) of the Investment Advisers Act against a hedge fund manager that registered as a result of the hedge fund adviser registration rule and withdraws its registration in light of *Goldstein* without regard to whether the hedge fund manager (i) held itself out generally to the public while it was registered and/or (ii) had more than fourteen (14) clients while registered (counting each private fund as a single client).

Please note, however, that a hedge fund manager relying on this position must withdraw its registration with the SEC no later than February 1, 2007. For the first twelve (12) months following withdrawal from SEC registration, the manager may, for purposes of assessing its eligibility for the Section 203(b)(3) exemption, determine the number of clients it has had by reference to a period of time beginning on the date of withdrawal, which may be a period of less than twelve (12) months.

Form ADV-W Balance Sheet Requirement

To withdraw registration, an investment adviser must file Form ADV-W electronically through the Investment Adviser Registration Depositary ("IARD"). Item 7 of Form ADV-W requires an adviser to complete a balance sheet prepared in accordance with generally accepted accounting principles if the adviser responds affirmatively to one of the items on Form ADV-W involving custody, money owed to clients, or judgments and liens. Because most hedge fund advisers have custody of client assets, but are no longer required to file a balance sheet with the SEC in connection with their annual update of the Form ADV, the SEC staff will not recommend enforcement action to the SEC if a hedge fund adviser that registered as a result of the hedge fund adviser registration rule and that withdraws from registration in reliance on the Section 203(b)(3) exemption by February 1, 2007, does not provide the information required in a balance sheet on Form ADV-W, Schedule W2 as a result of a "yes" answer to Item 3 of Form ADV-W. Please note that investment advisors that have a "yes" answer to Item 3 of Form ADV-W must complete a Schedule W2, but may enter "0" for all entries on such Schedule W2.

OTHER MATTERS NOT RAISED BY LETTER

In the No-Action Letter, the SEC took the opportunity to address two other matters not raised by the ABA letter which the SEC believes will be of interest to hedge fund managers.

Form ADV

In connection with the adoption of the hedge fund adviser registration rule, the SEC made several changes to Part 1A of Form ADV and Schedule D. Such changes required applicants to identify and provide certain information on the "private funds" they advise. Although *Goldstein* has vacated such changes, due to system and programming constraints, the Form ADV as it appears on the IARD will continue to reflect the form changes. The SEC has directed its contractor to make the necessary changes to IARD programming to revert the Form ADV back to the version that was in effect immediately prior to the adoption of the hedge fund adviser registration rule. The SEC staff will post additional guidance on how registered investment advisers may complete Form ADV until these changes are implemented on the IARD; such guidance will be found at http://www.sec.gov/divisions/investment/iard.shtml

Access to Records

When it adopted the hedge fund adviser registration rule, the SEC also adopted an amendment to Rule 204-2 that provided that the records of a private fund are the records of the adviser if the adviser or any related person acts as the private fund's general partner, managing member or in a comparable capacity. The No-Action Letter provides that a registered investment adviser must make such records available for examination in accordance with Section 204 of the Investment Advisers Act and may not evade this requirement by holding records by or through any other person, including a related person or private fund.

We will continue to keep you advised of developments. At the hearing before the Senate Banking Committee in July, Chairman Cox also announced that the SEC would consider additional rule-making with regard to hedge funds. We will advise clients as any such initiatives are introduced in the future.

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