K&LNG Alert

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Hedge Funds

SEC Staff Issues Guidance to Hedge Fund Advisers on Continued Registration and Potential Deregistration

On August 10, 2006, the staff of the Securities and Exchange Commission ("SEC") issued a no-action letter providing guidance in the wake of the D.C. Circuit Court of Appeals decision in *Goldstein v. Securities and Exchange Commission* (the "Goldstein decision"), which vacated the rule (the "Rule") requiring most hedge fund advisers to register as investment advisers under the Investment Advisers Act of 1940. The American Bar Association requested the guidance because of the scope of the Goldstein decision, which vacated not only the Rule, but also the accompanying rules, interpretations and transitional provisions that facilitated registration of hedge fund advisers and that were adopted concomitantly ("Accompanying Provisions"). The no-action letter permits advisers that choose to remain registered to continue to rely upon certain of these Accompanying Provisions, and also grants certain relief to those advisers that choose to deregister.

With respect to a hedge fund adviser that chooses to remain registered, the no-action letter provides that:

- An offshore adviser to a private fund organized and incorporated outside the United States may continue to treat such fund as the "client" for most purposes under the Investment Advisers Act, in accordance with prior guidance and letters.
- An adviser may continue to rely upon the Accompanying Provisions that permitted the adviser to use performance information from the period prior to February 10, 2005 with significantly less back-up material than would otherwise be required under the Investment Advisers Act.
- An adviser may continue to collect performance-based compensation from private funds with investors who are not "qualified clients," and from other clients who do not constitute "qualified clients" under the Investment Advisers Act, as would otherwise be required but for the Accompanying Provisions, provided that the investment by such an investor or the advisory contract with such a client predates February 10, 2005.
- For the purposes of the custody rule, an adviser to a fund-of-funds may continue to rely upon the Accompanying Provisions, which allowed such an adviser 180 days to deliver audited financial statements to investors in a fund-of-funds, rather than the 120-day limit that would otherwise be applicable.

With respect to a hedge fund adviser that chooses to deregister, the no-action letter provides that:

- An adviser that registered in reliance on the Rule may, going forward, rely upon the exemption from registration for advisers with fewer than 15 "clients" provided in Section 203(b)(3) of the Investment Advisers Act (which after the Goldstein decision would again constitute a private fund, rather than the investors in such fund, so long as advisory services are provided to the fund as a whole and not the individual investors), regardless of whether it "held itself out" to the public as an investment adviser during the period of its registration or had more than 14 clients during the period of its registration. For a 12 month period after the date of withdrawal of its registration, the adviser may use the number of clients it had at the time of withdrawal in

determining the applicability of the 14 client exemption. The staff notes, however, that an adviser seeking to rely on this provision of the no-action letter must withdraw its registration no later than February 1, 2007.

- An adviser that withdraws its registration by February 1, 2007 will not be required to provide a balance sheet in connection with such withdrawal, as would otherwise be required by the requisite filing.

The staff addressed two additional points not raised by the American Bar Association's request for guidance. First, the no-action letter states that the Form ADV will revert to the form it took prior to the adoption of the Rule and its Accompanying Provisions. The amendments to Part 1A and Schedule D of the Form ADV Part 1 requiring an adviser to list the "private funds" it advises will be removed. Given the system and programming issues involved in altering the Form ADV on the Investment Adviser Registration Depository, however, the amendments to the Form ADV will continue to appear until such alterations can be effected. The staff has stated that interim instructions for completing the Form ADV Part 1 will be posted at www.sec.gov/divisions/investment/iard.shtml. Second, the no-action letter notes that certain Accompanying Provisions provide that the records of a private fund will be deemed to constitute records of its adviser if the adviser or a related person acts as general partner, managing member or in a similar capacity with respect to the fund. Although this Accompanying Provision was vacated by the Goldstein decision, the staff notes that a registered adviser may not evade its obligation under the Investment Advisers Act to provide records for examination by the staff by "holding records by or through any other person, including a related person or private fund."

Nicholas S. Hodge
617.261.3210
nhodge@klng.com

Jarrod R. Melson
202.778.9349
jmelson@klng.com

If you have questions or would like more information about K&LNG's Hedge Fund Practice, please contact one of our lawyers listed below, or send general inquiries via e-mail to hedgefunds@klng.com.

BOSTON

Mark P. Goshko	617.261.3163	mgoshko@klng.com
Nicholas S. Hodge	617.261.3210	nhodge@klng.com

LONDON

Philip J. Morgan	+44.20.7360.8123	pmorgan@klng.com

LOS ANGELES

William P. Wade	310.552.5071	wwade@klng.com

NEW YORK

Beth R. Kramer	212.536.4024	bkramer@klng.com
Richard D. Marshall	212.536.3941	rmarshall@klng.com

SAN FRANCISCO

David Mishel	415.249.1015	dmishel@klng.com
Mark D. Perlow	415.249.1070	mperlow@klng.com

WASHINGTON

Cary J. Meer	202.778.9107	cmeer@klng.com
Robert H. Rosenblum	202.778.9464	rrosenblum@klng.com

Kirkpatrick & Lockhart Nicholson Graham LLP

www.klng.com

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