WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

PROPOSED RULE REQUIRING REGISTRATION OF HEDGE FUND ADVISERS

At a meeting held on July 14, 2004, the Securities and Exchange Commission (the "Commission"), by a three-to-two vote, approved the release of a proposed rule that would require private investment fund managers to register as investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act"). We expect the Commission to issue the proposed rule within the next few days. At the meeting, Commissioner Atkins, who voted with Commissioner Glassman against the proposal, asked Paul Roye, Director of the SEC's Division of Investment Management, what comments might be made that would dissuade the Division from recommending adoption of the proposal. While Mr. Roye did not offer any specific ideas, the Commission will nevertheless accept comments on the proposal through September 15, 2004.

Section 203(b)(3) of the Advisers Act exempts from registration investment advisers which during the course of a twelve-month period have fewer than fifteen clients and which meet certain other conditions. Rule 203(b)(3)-1 under the Advisers Act currently 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 investment objectives of its owners is treated as a single client. Under this rule as currently in effect, private investment fund managers that comply with the other terms of Section 203(b)(3) can advise up to fourteen private funds in any twelve-month period without registering under the Advisers Act.[1]

The proposed rule would modify Rule 203(b)(3) and require investment advisers to count each investor in a private fund as a client for purposes of Section 203, thus effectively eliminating the exemption for virtually all managers of hedge funds, other than managers of investment vehicles used for other purposes, such as long-term venture capital funds and certain other private investment companies used as, for example, structured finance vehicles. If the proposal is adopted, an investment adviser advising one private investment fund with fifteen investors would be required to register under the Advisers Act. As described at the Commission's July 14th meeting, the proposed rule would also require a look through to the ultimate investors in any fund of hedge funds. Accordingly, absent some other exemption or clarification in the proposed rule when issued, an investment adviser managing assets for a single fund of hedge funds investor would be subject to registration under the Advisers Act unless the adviser ascertains that the fund of hedge funds has fewer than fifteen investors.

---

1 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 be subject to investment adviser registration under state law.

The proposed rule will not apply to private investment funds that do not permit redemptions for at least a two-year period following an investment.[2] The Commission has not yet issued the formal release containing and discussing the proposed rule. From the Commission's discussion of the proposed rule at its meeting, it is unclear if other forms of limited liquidity, short of an absolute two-year lock-up, will permit an adviser to treat a fund as a single client. We will analyze the proposed rule upon its release and advise our clients should we believe any such alternatives are available.

Investment advisers with less than $25 million under management will continue to be ineligible to register under the Advisers Act, regardless of the number of clients they advise. Such advisers will generally be required to register under applicable state law.[3]

The Commission has indicated that, by this proposal, it does not intend to impose any restrictions on the investment strategies of private investment funds. Investment advisers will, however, become subject to a number of compliance requirements thought to advance investor protection, including the requirement to adopt written compliance policies and procedures and to designate a chief compliance officer.

The proposed rule as described by the Commission's Staff at the meeting will include two limited exemptions from certain requirements of the Advisers Act. Registered investment advisers are generally prohibited from charging a performance fee to clients who are not "qualified clients." Qualified clients are generally 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 proposed rule will "grandfather" from this requirement investors in a private investment fund that were investors before the adviser was required to register under the proposed rule as adopted. Absent this exemption, advisers to private investment funds would have to require investors that are not qualified clients to withdraw from the investment fund before the adviser registers under the Advisers Act.[4] Commission Staff also indicated that the proposed rule will provide limited relief from the Advisers Act rule requiring certain records to be maintained that demonstrate the accuracy of any performance information used by an investment adviser to the extent such performance relates to periods prior to the investment adviser's registration under the Advisers Act.

---

[2] Most private equity funds and venture capital funds will be treated as single clients under this exception.

[3] 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 rescind such exemptions, there may be a significant time lag until that occurs.

[4] Private investment funds exempted from investment company registration pursuant to Section 3(c)(7) of the Investment Company Act of 1940 are not subject to the restriction on performance fees.

The proposed rule also will modify an exemption available to pooled investment vehicles under Rule 206(4)-2 (the "Custody Rule"). Currently, advisers to pooled investment vehicles (such as private investment 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. The proposed rule would extend the required delivery date to 180 days after the end of the fiscal year. This extension was principally designed for funds of hedge funds that are often 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.

We will circulate a more detailed memorandum when the text of the proposed rule is made public.

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

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, Martin R. Miller at (212) 728-8690, Rita 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. Our telephone number is (212) 728-8000, and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

July 15, 2004