SEWARD & KISSEL LLP

August 24, 2006

Memorandum to Our Investment Management Clients and Friends

Hedge Fund Adviser Registration Rule Vacated

Introduction

On June 23, 2006, the U.S. Court of Appeals for the District of Columbia Circuit issued its ruling in connection with the case commenced last year that challenged the SEC's authority to pass the SEC "hedge fund adviser" registration rule in 2004, which rule required most hedge fund managers to register as investment advisers with the SEC. In its ruling, the Court stated, among other things, that the SEC had not adequately explained the rationale for its change from its prior interpretation and that the rule was arbitrary. Accordingly, the Court determined that the rule be vacated and remanded once the SEC decided whether it would appeal the decision. On August 7, 2006, SEC Chairman Christopher Cox announced that the SEC would not appeal the Court's decision and the Court issued its final mandate to make the decision effective on August 18, 2006.

Hedge fund managers who were required to register under the hedge fund adviser registration rule and who wish to de-register may do so by filing Form ADV-W electronically through the IARD system. While an unregistered hedge fund manager generally must ensure that over the preceding 12 month period it has not held itself out to the public as an investment adviser and has had no more than 14 clients (counting each fund and managed account as a client) (the "14 client test"), the SEC staff has granted relief for registered hedge fund advisers seeking to de-register prior to February 1, 2007 who failed to meet the above criteria [1]. Moreover, hedge fund managers who did not register under the hedge fund adviser registration rule in reliance on the two year lock-up exception, may now eliminate such lock-up, if they so desire.

SEC Chairman Cox indicated that the SEC would soon propose new anti-fraud rules and other regulations. The SEC staff is also considering whether to increase the minimum asset and income requirements for hedge fund investors.

In light of the foregoing, registered hedge fund advisers must now decide whether or not to remain registered[2]. Set forth below are some of the factors that should be considered when making this decision.

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[1] The staff of the SEC's Division of Investment Management issued an interpretive letter to the American Bar Association on August 10, 2006 (the "ABA Letter") in which it stated that it would not recommend enforcement action if a registered hedge fund adviser seeking to de-register held itself out to the public while it was registered and/or exceeded the "14 client test" while it was registered, provided that the adviser withdraws its registration by no later than February 1, 2007. The ABA Letter goes on to state that for the first 12 months following de-registration, the adviser may determine the number of clients it has had by reference to a time period beginning on the date of de-registration, which may be a period of less than 12 months.

[2] In the case of non-U.S. advisers who registered under the "registration light" regime, they must decide whether to de-register or remain registered. If they elect to remain registered, they must become fully compliant with the Investment Advisers Act of 1940 with respect to their U.S. clients (including implementing a compliance manual and related program).

De-Registration Considerations

- De-registration may affect the ability to attract investors who require or prefer some form of registration. It is our understanding that certain institutional investors favor registered advisers, because such advisers may be subject to, among other things, audit by the SEC, an independent regulatory body.

- De-registration may decrease the ability to access ERISA assets. Generally, in order for an investment manager to manage a fund that exceeds the 25% benefit plan investor level in any class, the investment manager should be a "qualified professional asset manager" (which entails, among other things, registered adviser status).

- Once an adviser de-registers, it will no longer be able to take advantage of certain reporting exemptions that may be available to it under Sections 13 and 16 of the Securities Exchange Act of 1934.

- There is uncertainty as to any upcoming legislation affecting hedge fund manager registration. The SEC or Congress may pass or enact new regulations affecting hedge fund advisers in the future, and an adviser that de-registers and dismantles its compliance program may have to reinstate it in some form at a later date. Moreover, even if the SEC or Congress does not act, there are no assurances that the states will not intervene. For example, Connecticut, California and Texas are some of the states that currently would require state registration of many advisers based in those states, absent SEC registration of the adviser.

- For advisers who elect to remain registered, the ABA Letter preserves the relief that was afforded by various ancillary changes that were passed along with the hedge fund adviser registration rule (i.e., grandfathering of qualified client status for pre-February 10, 2005 investors, grandfathering of the need to maintain certain pre-February 10, 2005 performance records, and 180 days for a fund-of-funds to comply with the custody rule account statement exception).

- Notwithstanding the prior points, an adviser that de-registers may be able to (i) save certain ongoing compliance costs associated with remaining registered, (ii) devote greater attention to money management matters, (iii) target a broader group of investors, and (iv) avoid SEC registered adviser audits.

Recommendations

While each registered adviser is different and must weigh the above considerations along with its own unique circumstances, we recommend that any adviser that elects to de-register consider keeping a compliance infrastructure in place, based upon our view that such infrastructure comports with good business practices and also minimizes the costs and efforts that would be involved should registration again become necessary or desirable. Of course, many advisers may determine that the best practices approach would be to remain registered and continue as if the rule had not been overturned.

If you have any questions regarding the foregoing, please contact your primary attorney in the Investment Management Group at Seward & Kissel LLP.

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