MINTZ LEVIN
COHN FERRIS
GLOVSKY AND
POPEO PC

BOSTON
WASHINGTON
RESTON
NEW YORK
NEW HAVEN
LOS ANGELES
LONDON

www.mintz.com

One Financial Center
Boston, Massachusetts 02111 USA
617 542 6000
617 542 2241 fax

701 Pennsylvania Avenue, N.W.
Washington, D.C. 20004 USA
202 434 7300
202 434 7400 fax

666 Third Avenue
New York, New York 10017 USA
212 935 3000
212 983 3115 fax

12010 Sunset Hills Road
Reston, Virginia 20190 USA
703 464 4800
703 464 4895 fax

157 Church Street
New Haven, Connecticut 06510 USA
203 777 8200
203 777 7111 fax

Water Garden
1620 26th Street
Santa Monica, California 90404 USA
310 586 3200
310 586 3202 fax

The Rectory
9 Ironmonger Lane
London EC2V 8EY ENGLAND
+44 (0)207 726 4000
+44 (0)207 726 0055 fax

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SEC Proposes Registration Requirements for Hedge Fund Advisors

The U.S. Securities and Exchange Commission (SEC) recently proposed new Rule 203(b)(3)-2 and certain other amendments to existing rules under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The new rule would require most hedge funds and "funds-of-funds" managers to register as investment advisers with the SEC. Most private equity and venture capital fund managers likely would not need to register under the new rule.

The Advisers Act exempts an adviser from registration if it: (1) has had fewer than 15 U.S. clients during the preceding 12 months; (2) does not hold itself out generally to the public as an investment adviser; and (3) is not an adviser to any registered investment company. Currently a "private fund" counts as one client if the advice provided is based on the investment objectives of the fund rather than the individual investors. The proposed rule would require each owner of an interest in a private fund to be counted as a client.

Proposed Rule 203(b)(3)-2

Proposed rule 203(b)(3)-2 would require investment advisers to count each owner of a "private fund" (defined in the following paragraph) as a client for purposes of determining the availability of the private adviser exemption of section 203(b)(3) of the Advisers Act. Consequently, an adviser to a "private fund" would be required to "look through" to the owners of the private fund in determining if the adviser, during the course of the preceding 12 months, had more than 14 clients.

Definition of "Private Fund"

The proposed rules provides that a "private fund" would now be any fund: (1) that is subject to regulation under the Investment Company Act of 1940, as amended, ("Investment Company Act") but for the exception provided in either section 3(c)(1) (privately offered, no more than 100 holders of all securities, no plans to make a public offering) or section 3(c)(7) (privately offered and all the holders, with certain exceptions, are "qualified purchasers," or individuals and/or entities with certain very high levels of investment ownership) of the Investment Company Act; (2) permits its investors to redeem their interests in the fund within two years of purchasing them; and (3) in which interests are offered based on the ongoing investment advisory skills, ability or expertise of the investment adviser. Since hedge funds typically offer their investors liquidity access following an initial lock-up period, most hedge fund advisors would be included within the rules while most private equity and venture funds would be excluded.

Funds of Hedge Funds

The proposed rule contains a special provision regarding the calculation of clients for advisers to private funds in which a registered investment company invests. Private fund advisers would be required to count all investors in the registered fund, which invests in the private fund, as clients. In the absence of this provision, a fund adviser can provide its services to thousands of mutual fund investors through 14 or fewer mutual funds, each of which could invest in the private fund, and each of which would count as a single client.

Minimum Assets Under Management

The proposed rule does not alter the minimum assets under management that an investment adviser must have in order to be eligible to register with the SEC. Hedge fund advisers managing assets of less than $30 million would continue to be subject to state regulation (unless they also advise a registered investment company or must otherwise register under an exemptive rule).

Offshore Advisers

The proposed rule would require hedge fund advisers located offshore to look through the funds they manage, whether or not those funds are also located offshore, and count investors that are U.S. residents as clients. Offshore advisers to hedge funds would, therefore, be treated in the same manner as any other type of offshore adviser providing advice to U.S. residents. The proposed rule contains an exception to the definition of "private fund" for a company that has its principal office and place of business outside the U.S., makes a public offering of its securities outside the U.S., and is regulated as a public investment company under the laws of a country other than the U.S.

Impact of Proposed Rule

Although all advisers, whether registered or unregistered are currently subject to the anti-fraud provisions of the Advisors Act, registration would require (1) the filing of registration forms, (2) maintenance of business records in accordance with SEC rules, (3) adopting and implementing compliance programs and procedures, (4) compliance with custody rules of the SEC, (5) compliance with certain restrictions on the receipt of performance fees (such fees would be prohibited from being charged to fund investors with less than $1.5 million in net worth, although investors existing at the time of enactment of the rule would not be included in this prohibition), (6) compliance with qualification requirements of persons associated with advisors, and (7) otherwise being subject to SEC oversight.

Rationale of the Proposed Rule

Among the SEC's reasons for the proposed registration requirements are the increasing number and size of hedge funds, the growing number of fraud cases brought against hedge fund managers, and the broadening group of smaller investors, pensioners and other market participants concerned with hedge funds' activities.

Status of the Proposed Rule

No rule has yet been adopted. We do not know yet if one will be adopted and if so, to what extent it will resemble the proposed rule. Mintz Levin can assist funds in the registration process or in assessing their registration requirements. For further information, please visit www.mintz.com for a full listing of our Business and Finance attorneys and their contact information.