On July 14 the Securities and Exchange Commission voted to publish for comment a proposed new rule that would require certain hedge fund managers to register with the Commission under the Investment Advisers Act of 1940. The Commission will accept comments to the proposed new rule through September 15, 2004.

The proposed new rule would require an adviser to one or more “private funds” to register with the Commission if the adviser manages at least $25 million of clients’ assets and the adviser has more than 14 “clients” in any 12-month period. For this purpose, the new rule would require each investor in a private fund (and each indirect investor participating through a fund of hedge funds) to be counted as a separate client.

Under the proposed new rule, a “private fund” would be one that:

- would be an investment company but for the exceptions in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940
- permits owners to redeem their ownership interests within two years of purchase (other than exclusively on the basis of extraordinary circumstances), and
- is offered based on the investment advisory skills, ability or expertise of the investment adviser.

(This definition is designed to include most hedge funds, while excluding private equity and venture capital funds.)

The Commission also proposed related rule amendments designed to address certain transitional issues. These would:

- permit “grandfathered” hedge fund investors who do not satisfy the investor eligibility criteria for performance fees charged by registered advisers to maintain their existing hedge fund investments after registration by the fund’s adviser.
• permit newly registered advisers to use past performance data from their pre-registration period without requiring that the adviser maintain all of the corroborating records normally required for registered advisers, and

• extend the deadline applicable to managers of funds of hedge funds for the provision of audited financial reports to fund investors from 120 days to 180 days after the end of each fiscal year. (Currently, managers who do not meet the 120-day deadline can become subject to burdensome requirements under the custody rule for registered advisers.)

The proposed rules would contain special provisions designed to limit the scope and impact of the application of the Advisers Act in the case of offshore advisers to offshore funds that have more than 14 U.S. investors.

The Commission believes that the new rule would permit it to:

• collect and provide to the public basic information about hedge funds and hedge fund advisers, including the number of hedge funds operating in the United States, the amount of assets and the identity of their advisers

• examine hedge fund advisers to identify compliance problems early and deter questionable practices. If fraud does occur, examinations offer a chance to discover it early and limit the harm to investors

• require all hedge fund advisers to adopt basic compliance controls to prevent violation of the federal securities laws

• improve disclosures made to prospective and current hedge fund investors, and

• prevent individuals with past criminal or other serious disciplinary records from managing hedge funds.

As expected, the five SEC commissioners were sharply divided on the merits of the proposal, with Chairman Donaldson and the two Democratic commissioners voting in favor, and the other two Republican commissioners voting against the proposal.