

PROPOSED NEW RULE CHANGES TO HEDGE FUNDS

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The Securities and Exchange Commission voted on July 14, 2004 to propose new Rule 203(b)(3)-2 (the "New Rule") that would require hedge fund advisers to register with the Commission under the Investment Advisers Act of 1940 as amended. The Commission also voted to propose related rule amendments and asked for public comment due by September 15, 2004. While there can be no assurance that these rules will be adopted, we believe that change in hedge fund regulation is likely.

The proposed New Rule would require all advisers to "private funds" (having more than 15 investors with assets of \$25,000,000) to register as investment advisers with the Commission and would require the advisers to count the number of investors in each "private fund" to determine if the General Partner needs to register as an investment adviser. (Formally the fund itself was counted as one investor and the proposed rule would require that each individual investor be counted separately to determine if there were more than 15 investors which would trigger investment adviser registration of the General Partner.).

The proposed New Rule would define a "private fund" as a fund which (i) is exempt from registration as an investment company under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940; (ii) allows owners to redeem their interests within two years of purchase; and (iii) is offered based on the investment advisory skills, ability or expertise of the investment adviser.

There will be no change to Rule 203A-1 of the Adviser's Act, which provides that investment advisers with less than \$25 million under management are not required to register with the SEC.

Registration under the New Rule would permit the Commission 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.
- 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.

The proposed rule would contain special provisions for advisers located outside of the United States designed to limit the extraterritorial application of the Advisers Act to offshore advisers to offshore funds that have United States investors.

PROPOSED AMENDMENT OF RECORDKEEPING RULE

The SEC is also proposing to amend the Advisers Act recordkeeping rule to permit a registered adviser to use performance information relating to the period prior to its registration without being subject to the normal requirement that it maintain records supporting that performance information. This amendment is intended to help assure that hedge fund advisers required to register as a result of Rule 203(b)(3)-2 are not deprived of the ability to use performance information for periods prior to their registration.

Another proposed amendment to the recordkeeping rule would enhance the ability of the SEC staff to gain access to and inspect the books and records of private funds advised by registered investment advisers or their affiliates (e.g., the general partner of a fund).

PROPOSED AMENDMENT OF PERFORMANCE FEE RULE

The SEC is proposing to incorporate a "grandfather" provision into Rule 205-3 under the Advisers Act under which a registered adviser that advises a Section 3(c)(1) fund would be permitted to impose incentive fees and allocations on investors in that fund who are not "qualified clients" if they invested in the fund prior to the adviser's registration. Generally, a "qualified client" is a person who has a net worth of more than \$1.5 million with at least \$750,000 of assets under the management of the fund's investment adviser, at the time of investment.

PROPOSED AMENDMENT OF FORM ADV

The SEC is proposing to amend the Form ADV, the investment adviser registration form, to require that registered advisers provide information as to the number of hedge funds they manage.

PROPOSED AMENDMENT OF CUSTODY RULE

The SEC is proposing to amend the custody rule under the Advisers Act to provide greater flexibility to investment advisers of fund of funds. In this regard, Rule 206 (4)-2 would be amended to extend from 120 days to 180 days after such fiscal year-end the time within which a registered adviser must deliver the audited financial statements of a fund of funds it manages to investors. Advisers of fund of funds have been concerned that the current 120-day period is insufficient because audits generally cannot be completed until audits of the underlying hedge funds in which they invest are completed.

We note hereby the above are merely proposed changes, some or all of which may or may not ultimately be adopted. Since they represent significant potential changes to existing law and regulation, however, we feel they are important for anyone involved in the Hedge Fund industry to be aware of. If you have any questions, please do not hesitate to call Richard Heller at (212) 688-5900.

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