

ROBERT G. HUTCHINS – LEGAL BULLETINS

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A hedge fund and its adviser are exempt from registration under current law if, among other things, the fund has fewer than 100 equity owners, the fund does not engage in a public securities offering, the adviser does not advertise publicly and the adviser had fewer than 15 “clients” during the preceding 12 months. For exemption purposes, a fund counts as one “client” if the adviser is guided by the fund’s investment objectives, not those of its owners.

On July 20, the SEC proposed that hedge fund advisers managing more than \$30 million be required to register. The proposal has generated considerable debate and a strongly worded dissent. The comment period will expire September 15. One aspect of the proposal will be of special interest to advisers and small investors. Rule 205-3 authorizes *registered* advisers to charge performance fees only to “qualified clients,” clients that invest at least \$750,000 with the adviser or have a net worth of at least \$1.5 million. The performance fee Rule “looks through” the relevant fund to its equity owners each of whom must be “qualified.”

Many \$30 million hedge funds have non-qualified owners. If the advisers to such funds must now register, and Rule 205-3 is not amended, non-qualified owners must either exit the funds or be excluded from the performance component of the adviser’s fee. To provide relief, the SEC proposes to amend the Rule to allow existing non-qualified owners to retain or even add to their investments while continuing to pay a performance fee. On a going-forward basis, newly registered hedge fund advisers and their investors would be bound by the performance fee rule.

For several reasons, including the possibility of a retroactive cut off date, I would hesitate to recommend the immediate formation of a hedge fund to lock-in non-qualified investors or a rushed investment by such investors to get themselves grandfathered. Nevertheless, it is worth noting that a window for small investors willing to bet on hedge funds may be closing.

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