COURT REJECTS SEC RULE REQUIRING INVESTMENT ADVISOR REGISTRATION FOR HEDGE FUND MANAGERS

The U.S. Court of Appeals for the District of Columbia rejected the Securities and Exchange Commission's recently-adopted rule requiring most hedge fund managers to register as investment advisors under the Investment Advisors Act of 1940.

Generally, Section 203(b) of the Advisors Act exempts from registration under the Advisors Act any investment advisor who, during the preceding twelve months, had fewer than fifteen clients and did not hold itself out generally to the public as an investment advisor. Advisors Act Rule 203(b)(3)-1 provided a safe harbor so that a fund advisor need only count the fund as one client rather than "looking through" the fund to count each of the investors.

The SEC's hedge fund rule would have required registration by managers of most hedge funds and potentially some private equity and venture capital funds. The hedge fund rule required, for purposes of determining the number of clients under Section 203(b)(3), that fund managers look through and count the owners of each "private fund" managed by the fund manager. The SEC hedge fund rule defined a "private fund" as any company

- that would be an investment company under the Investment Company Act of 1940 but for the exceptions under Section 3(c)(1) or 3(c)(7) of such Act,
- that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests, and
- interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.

The court, calling the SEC's hedge fund rule "arbitrary," held that the rule was a result of an unreasonable interpretation of the word "client" in the Advisors Act and, therefore, the rule was invalid.