WACHTELL, LIPTON, ROSEN & KATZ

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To Our Clients

Hedge Funds; The Fleschner Becker Case

On February 25, 1977, the Second Circuit held that the general partner of a hedge fund is an "adviser" within the Investment Advisers Act of 1940. This means that the general partner of any hedge fund with more than 14 limited partners must register under the Advisers Act. The Advisers Act prohibits the percentage of appreciation arrangement for the general partner that is common to most hedge funds.

The *Fleschner Becker* case provides a basis for the SEC to force adviser registration of the general partner of every sizeable hedge fund and concomitantly to eliminate percentage of appreciation compensation. As a practical matter, if the decision stands, it is the death knell of the hedge fund.

The *Fleschner Becker* case also held that a limited partner may sue the general partner for damages for violation of the antifraud provisions of the Advisers Act. The opinion did not cite the *Piper* case decided by the Supreme Court on February 23 and, at least in approach, is contrary to the *Piper* case. The damage holding, however, was relatively narrow being based on an allegation of deliberate concealment of the fact that a major portion of the fund's investments were in letter stock. The court did not say that the limited partner could recover for a loss in value merely because the general partner was not registered. Indeed, it is not clear whether the court even considered this issue. While, the damage part of the case is disturbing, it does not have the significance of the general partner-adviser holding which is devastating.

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