THE PROPOSED HEDGE FUND TRANSPARENCY ACT: IT'S NOT JUST FOR HEDGE FUNDS

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To Our Clients and Friends:

In the debate concerning increased regulation of the financial system, it appears to be a given that hedge funds and their managers will become subject to increased oversight. On January 29, Senators Grassley (R-IA) and Levin (D-MI) introduced "The Hedge Fund Transparency Act," which sets forth a potential approach to this increased oversight.

Notwithstanding its title, the bill is not limited to hedge funds. Senator Levin made this clear in his remarks introducing the bill:

> The bill imposes these requirements on all [private funds]. A wide variety of entities invoke those sections to avoid those requirements and SEC oversight, and they refer to themselves by a wide variety of terms – hedge funds, private equity funds, venture capitalists, small investment banks, and so forth. Rather than attempt a futile exercise of trying to define the specific set of companies covered by the bill . . ., the bill applies to any investment company that has at least $50 million in assets or assets under its management.

This is a significant departure from the approach that the Securities and Exchange Commission ("SEC") had taken in seeking to register hedge fund advisers under the Investment Advisers Act (an effort that was subsequently overturned by the D.C. Court of Appeals).[1] The SEC had sought to avoid imposing registration requirements on managers of venture capital and private equity funds by focusing on funds that provided investors an opportunity to redeem their interests within two years of purchase. The Department of the Treasury had taken a similar approach in its proposed anti-money laundering rules.

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[1] *The approach of registering fund managers was recommended by a report recently issued by the Group of Thirty, a private nonprofit international body composed of very senior representatives of the private and public sectors and academia, which is currently chaired by Paul Volker. The G-30 report also recommended that a "prudential regulator" of such managers have authority to require periodic regulatory reports and public disclosures of appropriate information regarding the size, investment style, borrowing and performance of the funds under management, as well as the authority to impose on "funds above a size judged to be potentially systemically significant" appropriate standards for capital, liquidity and risk management.*

The Grassley-Levin bill would require hedge funds, private equity funds and other private funds to register with the SEC under the Investment Company Act of 1940 ("Investment Company Act"). While it does not appear that the bill is designed to subject private funds to the same expansive regulation as mutual funds and other types of registered investment companies, private funds would be subject to reporting, books and records, and anti-money laundering requirements. In addition, they would have to cooperate with SEC examination requests.

The bill does not address its applicability to funds organized outside of the United States. We would expect that issue to be addressed by any final legislation or by the SEC.

THE PROPOSED FRAMEWORK; INVESTMENT ADVISER REGISTRATION?

Currently, private funds generally rely on the exceptions from the Investment Company Act regulation contained in either Section 3(c)(1) (for vehicles held by no more than 100 beneficial owners and that are not offered publicly) or 3(c)(7) (for vehicles held exclusively by "qualified purchasers" and that are not offered publicly). The proposed legislation would replace these Sections with new Sections 6(a)(6) and 6(a)(7), which largely replicate the existing provisions. This change is designed to make it clear that a private fund is an "investment company" for purposes of the Investment Company Act. (Currently, funds that rely on Section 3(c)(1) or 3(c)(7) are not, for purposes of the Investment Company Act, deemed to be investment companies.) Senator Levin characterized this as a "technical change," but it may have greater implications, particularly in light of the requirement that funds that rely on the new exemptions register with the SEC.

Many provisions of the Investment Company Act and the Investment Advisers Act are tailored to investment companies that are "registered" under the Investment Company Act. The bill does not, however, amend the two Acts to differentiate between "public" investment companies that register under Section 8 of the Investment Company Act and private funds that would register under Section 6. Based on Senator Levin's remarks, it seems clear he does not intend that funds that register under the new provision would be subject to the regulatory provisions that apply to public mutual funds, but this will have to be clarified.

Similarly, it does not appear that the bill is designed to subject the managers of private funds to Investment Advisers registration, but that is not clear. The typical private fund manager relies on an exemption provided by Section 203(b)(3) of the Investment Advisers Act, which requires that the manager have fewer than 15 clients and that none of the clients be registered under the Investment Company Act. The bill does not amend Section 203(b)(3) to make it clear that the exemption continues to be available to managers of funds that are registered under the new provision.

CONDITIONS

Funds that rely on the new provisions would be exempt from all provisions of the Investment Company Act. However, if a fund has assets under management of $50 million or more, it must meet several conditions to fall within the exemptions:

- The fund must register with the SEC;
- The fund must file an information form ("Information Form") to be prescribed by the SEC;
- The fund must maintain such books and records as the SEC may require; and
- The fund must cooperate with any request for information or examination by the SEC.

THE INFORMATION FORM

The Information Form would be electronically filed at such time as the SEC may require, but at least every 12 months, and would be publicly available in an electronic searchable format. It would include at least the following information:

- The name and address of (i) each natural person who is a beneficial owner of the fund, (ii) any company with an ownership interest in the fund, and (iii) the fund's primary accountant and primary broker;[2]
- An explanation of the structure of ownership interests in the fund;
- Information on any affiliation that the fund has with another financial institution;
- A statement of any minimum investment commitment required of investors;
- The total number of investors; and
- The current value of (i) the assets of the fund and (ii) any assets under management by the "investment company." (It is unclear what the drafters meant by "investment company" in this context.)

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[2] *It is unclear whether there would be circumstances under which a fund would be required to "look through" a trust, partnership or similar entity to identify "natural person" beneficial owners for this purpose. The policy rationale for providing the names and addresses of these persons in a publicly available document is also unclear.*

SEC IMPLEMENTATION: MORE REGULATION?

The SEC would be required, within 180 days of enactment, to issue such forms and guidance as are necessary to carry out the bill. The SEC would also have the authority to "make a rule to carry out this Act." The scope of this rulemaking authority is not entirely clear. Senator Levin remarked that the bill "gives the SEC the authority it needs to impose additional regulatory obligations and exercise the level of oversight it sees fit over hedge funds to protect investors, other financial institutions, and the U.S. financial system as a whole." He also suggested that the SEC has the authority to impose additional disclosure requirements.

AML PROVISIONS

The bill would require private funds to adopt anti-money laundering programs and to be subject to suspicious activity reporting requirements. All private funds would be subject to these rules. An earlier Department of the Treasury rule proposal, subsequently withdrawn as unnecessary, would have been applicable only to private funds that provide investors with an opportunity to redeem their interests.

Under the bill, the Treasury, in consultation with the SEC and the CFTC, would be required to adopt a rule within 180 days that would require private funds to use risk-based due diligence policies, procedures and controls that are reasonably designed to ascertain the identity of and evaluate any foreign person (including, where appropriate, the nominal and beneficial owner or beneficiary of a foreign corporation or other entity) that provides, or plans to provide, funds to be invested with the advice or assistance of such investment company.

The bill would permit the rule to incorporate elements of the rule initially proposed by the Treasury, which suggests at least the possibility that private funds that do not provide redemption opportunities (*e.g.*, most private equity funds) might be exempt from the rule.

If the Treasury does not adopt such a rule, the bill's AML provisions would go into effect without further action one year after enactment.

THE FUTURE

We will continue to monitor the progress of this bill as well as other regulatory initiatives that will impact private funds or their sponsors.

Please feel free to contact us with any questions.

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