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February 10, 2009

Client Alert

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PROPOSED LEGISLATION REGULATING HEDGE FUNDS

On January 29, 2009, Senators Chuck Grassley (R-Iowa) and Carl Levin (D-Michigan) introduced legislation to create a regulatory regime for hedge funds. Entitled “The Hedge Fund Transparency Act of 2009”, the bill is a revised version of legislation originally introduced by Senator Grassley in 2007 intended to regulate hedge fund managers. At that time, Senator Grassley received little support for his proposal. In light of the current financial crisis, hedge fund regulation is now being considered more seriously. Both Timothy Geithner, the Secretary of the Treasury, and Mary Schapiro, the SEC Chairperson, have voiced support for the regulation of hedge funds. In 2008, hedge funds managed approximately \$1.8 trillion in assets.¹ According to Senator Levin, “[t]he problem is that hedge funds have gotten so big and are so entrenched in U.S. financial markets, that their actions can now significantly impact market prices, damage other market participants, and can even endanger the U.S. financial system and economy as a whole.”

The bill is intended to affect the result of the 2006 *Goldstein* decision issued by the U.S. Court of Appeals for the D.C. Circuit, which held that the Securities and Exchange Commission (the “SEC”) had exceeded its statutory authority by requiring the registration of hedge fund managers. Senator Levin has described the Hedge Fund Transparency Act as designed to close a “loophole” allowing hedge funds to operate under a “cloak of secrecy.”

The proposed legislation consists of certain technical amendments to the Investment Company Act of 1940, as amended (the “Investment Company Act”). Currently, funds can avoid registration as investment companies under the exceptions to the definition of investment company contained in Sections 3(c)(1) and 3(c)(7). Section 3(c)(1) excepts entities that have 100 or fewer beneficial owners and have not publicly offered their securities. Section 3(c)(7) excepts entities that are made up solely of “qualified purchasers” and have not publicly offered their securities. Under the new proposal, both sections would be relocated without any major changes in wording to Section 6 of

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¹ See Senator Carl Levin, Senate Floor Speech on Introduction of the Hedge Fund Transparency Act (Jan. 29, 2009), available at <http://levin.senate.gov/newsroom/release.cfm?id=307472>.

the Investment Company Act, which provides an exemption from registration as an investment company under Section 8 of the Investment Company Act, as opposed to an exception from the definition of investment company. By making what was previously an *exception* to the definition of an investment company into an *exemption* from registration as an investment company, the legislation signals that hedge funds will clearly be considered as investment companies under the Investment Company Act. Entities that were previously excluded from the definition under Sections 3(c)(1) and 3(c)(7) would thereby become subject to the regulatory authority of the SEC and subject to certain, but not all, provisions of the Investment Company Act.

Hedge funds and other entities that fall under the new Section 6 exemptions would be exempted from the Investment Company Act's full registration, filing, reporting, governance and other requirements. However, if the fund has assets or assets under management of \$50,000,000 or more, it would be required to meet several requirements in order to maintain its exemption from full registration and regulation as a "registered investment company." Under the proposal, the four main requirements would include the following:

- registration with the SEC;
- maintenance of books and records as required by the SEC;
- cooperation with any requests from the SEC for information or examination; and
- filing of a publicly-available electronic disclosure form annually with the SEC.

At a minimum, the annual disclosure form filed with the SEC would be required to include the following information:

- the names and current addresses of (a) all individuals who are beneficial owners of the investment company, (b) all companies with an ownership interest in the investment company, and (c) the investment company's primary accountant and primary broker;
- an explanation of the ownership structure of the investment company;
- information on any affiliation with other financial institutions;
- a statement of any minimum investment commitment required of a limited partner, member or investor;
- the total number of limited partners, members or other investors; and
- the current value of the investment company's assets and its assets under management.

The Hedge Fund Transparency Act would also subject entities relying on the new exemptions to anti-money laundering rules to be established by the Secretary of the Treasury (which would set forth minimum requirements for an anti-money laundering program) and to report any suspicious transactions.

As currently written, the legislation is quite broad in scope, classifying a wide variety of private funds as investment companies under the Investment Company Act. The new legislation would affect not only hedge funds, but also private equity funds,

venture capital funds, small investment banks, funds-of-funds and other private investment funds.

The legislation would also create a more burdensome disclosure system for hedge funds and the other regulated entities. As written, the proposal would require disclosure of the names and addresses of beneficial owners of investment companies with more than \$50,000,000 of assets or assets under management. It is likely that this requirement could discourage certain individuals and entities from investing in hedge funds and other investment companies that meet this definition. In an attempt to address this concern, Senators Grassley and Levin issued a statement on February 5, 2009, declaring that the “bill to regulate hedge funds does not require the disclosure of hedge fund clients who merely invest in the fund. ... [A]ny interpretation or characterization of our bill as requiring hedge funds to disclose their clients’ names is incorrect.” However, we note that by requiring the disclosure of personal information regarding “beneficial owners,” which includes limited partners, the legislation would extend to outside clients investing in private funds. This provision will likely be the subject of further discussion and debate as the bill moves through Congress.

It is not yet clear how the amendments would affect foreign entities. Currently, many foreign investment companies rely on the exceptions in Section 3(c)(1) or 3(c)(7) to offer securities inside the United States. These offshore entities are generally able to exclude foreign investors for the purpose of determining eligibility for the current exceptions. It is also not clear whether the proposed legislation will have retroactive effect and, if so, the extent of that.

The Hedge Fund Transparency Act of 2009 has now been referred to the Senate Committee on Banking, Housing and Urban Affairs. Although no amendments to the Investment Company Act have been introduced in the House of Representatives, Representatives Michael Castle (R-Delaware) and Michael Capuano (D-Massachusetts) recently introduced a package of legislation designed to regulate the hedge fund industry by amending the Investment Advisers Act of 1940 to require hedge fund managers to register with the SEC even if they have less than 15 clients; amending Title 1 of the Employee Retirement Income Security Act of 1974 to require pension plans to disclose any investments in hedge funds; and requiring the President’s Working Group on Financial Markets to conduct a comprehensive study of the hedge fund industry within 180 days of the bill’s enactment.

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