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CLIENT MEMORANDUM

Proposed Senate Bill Would Subject Private Funds to SEC Registration and Oversight

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A bill introduced in the Senate on January 29, 2009 would generally require private funds to register with the U.S. Securities and Exchange Commission (the "SEC") and impose other regulatory requirements, including the filing of information for public disclosure such as the identity of investors and the value of fund assets. The "Hedge Fund Transparency Act" (the "Bill") was introduced by senior senators Carl Levin (D-MI) and Chuck Grassley (R-IA). Despite the name of the Bill, it applies to all types of private funds and not just hedge funds.

ALL TYPES OF PRIVATE FUNDS REGULATED

Unlike recent unsuccessful regulatory efforts focused only on the hedge fund industry,[1] the Bill would apply to nearly all types of private funds. Aside from certain *de minimis* exclusions (*e.g.*, funds with assets of less than $50,000,000), all hedge funds, private equity funds and other private funds would be subject to the new regulations through proposed amendments to the definition of an investment company in the Investment Company Act of 1940 (the "Investment Company Act"). Traditionally, private funds have relied on exemptions from the definition of an investment company under the Investment Company Act pursuant to §3(c)(1) (exempting any issuer whose securities are privately placed and owned by no more than 100 investors) and §3(c)(7) (exempting any issuer whose securities are privately placed and owned exclusively by "qualified purchasers"). The Bill proposes to amend

[1] Recent unsuccessful efforts focused on the hedge fund industry by attempting to require investment advisers that managed investment vehicles offering redemptions of interests within the first two years of purchase to register under the Investment Advisers Act of 1940, as amended

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the definition of "investment company" by deleting those two exemptions in their entirety, moving them to become the new §6(a)(6) (formerly §3(c)(1)) and §6(a)(7) (formerly §3(c)(7)). The text of the replacement sections would remain largely the same, with the notable differences that funds falling under these sections would now be considered "investment companies" and any "large investment companies" (funds with assets of $50,000,000 or more) would be required to meet certain registration and reporting conditions in order to be excluded from the onerous regulatory requirements otherwise imposed on investment companies required to register under the Investment Company Act (*i.e.*, mutual funds).

PROPOSED REPORTING REQUIREMENTS

The Bill would impose the following registration and reporting requirements on any private fund relying on §6(a)(6) or §6(a)(7) with assets of $50,000,000 or more:

- Registration with the SEC
- Maintenance of such books and records as the SEC may require
- Cooperation with the SEC in regard to any request for information or examination
- The filing of an electronically-searchable "information form" at least once a year *to be made publicly available by the SEC* and to include information such as:
  - the names and current addresses of each natural person who is a beneficial owner of the fund, any company with an ownership interest in the fund and the primary accountant and primary broker of the fund,
  - 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 requirement,
  - the total number of investors, and
  - the current value of the assets of the fund and any assets under management by the fund (apparently on an aggregate basis rather than on an investment-by-investment basis).

The Bill's requirement of public disclosure of the names of private fund investors is likely to spark debate. The policy rationale for providing public disclosure of the names and addresses of investors in private funds is unclear and raises significant privacy concerns, especially for entities used in personal planning contexts.

ANTI-MONEY LAUNDERING OBLIGATIONS

In addition to reporting requirements, the Bill would impose an obligation on any fund relying on §6(a)(6) or §6(a)(7), regardless of its size, to establish an anti-money laundering program and report suspicious transactions to the SEC. Funds would be required to implement risk-based due diligence policies, procedures and controls reasonably designed to ascertain the identity of and evaluate any foreign person that supplies, or plans to supply, funds to be invested with the investment company's advice or assistance. The U.S. Treasury, in consultation with the SEC and the U.S. Commodity Futures Trading Commission, would be required to adopt a rule within 180 days that would require private funds to use anti-money laundering procedures as described above. The Bill states that the Treasury may incorporate elements of the rule that was proposed in September of 2002 and later abandoned by the Treasury. It is important to note that the Treasury's proposed rule would have applied only to those private funds that offered redemption opportunities within the first two years after an investment. It is possible that the new rule would also apply only to those funds and, therefore, would not apply to most private equity funds. Importantly, if the Treasury does not adopt a final anti-money laundering rule, the Bill's anti-money laundering provisions would go into effect without further action one year after the Bill's enactment.

POSSIBLE IMPLICATIONS

While the Bill does not elaborate beyond the conditions set forth above, it is conceivable that including private funds as "investment companies" under the Investment Company Act could have broader regulatory implications down the road.

The Bill would also have an impact outside of the private fund industry. For technical reasons, various types of non-fund entities, particularly foreign holding companies, structured finance issuers and personal planning vehicles, currently rely on either §3(c)(1) or §3(c)(7) of the Investment Company Act. As drafted, the Bill would also subject these entities to the Bill's registration and regulation requirements.

Notably, the Bill would amend the Investment Company Act, but not the exemptions from registration under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Because the Advisers Act generally requires any investment adviser to an investment company registered under the Investment Company Act to register under the Advisers Act, it appears that private fund sponsors may be forced to effect multiple registrations, with their fund entities registering under the Investment Company Act and their investment advisory entities registering under the Advisers Act.

It is unclear how the new requirement of public disclosure for private funds will be viewed in relation to the private placement exemption for interests under the U.S. Securities Act of 1933, as amended, and other restrictions on publicity relating to the offering of interests in private funds. It is also unclear how the Bill will apply to foreign investment companies that are permitted under current SEC interpretations to offer their securities privately to U.S. persons without registration under the Investment Company Act so long as either the §3(c)(1) or §3(c)(7) requirements are met with respect to the U.S. investors in the foreign investment companies.

As drafted, the Bill would cause any private fund that failed to comply with the requirements of the new exemptions to become automatically an unregistered investment company operating in violation of the Investment Company Act, with the serious consequences this entails (*e.g.*, potential voidability of contracts and a prohibition on engaging in interstate commerce).

The SEC is obligated to issue forms and guidance to implement the Bill within 180 days of the Bill's adoption. The SEC would also have authority to make rules to carry out the Bill. The scope of this rulemaking authority is unclear.

CONCLUSION

The Bill is one proposal for regulating private funds and their advisers, and its legislative prospects are unclear. However, given the current economic and political environment, it is likely that some form of enhanced private fund regulation will be implemented. We will continue to monitor the progress of the Bill and that of other regulatory developments that would have an effect on private funds and their managers.

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