



PROPOSED HEDGE FUND AND PRIVATE EQUITY FUND REGULATION

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In recent weeks there have been several proposals in the U.S. Senate and the U.S. House of Representatives that, if passed, would impose registration requirements on hedge funds, private equity funds, other privately-held funds and fund managers. This Client Alert describes the proposed regulations.

A. Hedge Fund Transparency Act of 2009

On January 29, 2009, Senators Chuck Grassley (R-IA) and Carl Levin (D-MI) introduced the "Hedge Fund Transparency Act of 2009" (the "**Transparency Act**"). The Transparency Act would amend the Investment Company Act of 1940 (the "**Investment Company Act**") and regulate funds in two major respects: (a) require registration with the Securities and Exchange Commission (the "**SEC**") for funds with assets of \$50 million or more and (b) impose more stringent anti-money laundering obligations.

Applies to Private Equity Funds and Hedge Funds

Despite having "hedge fund" in its name, the Transparency Act applies to private equity funds and hedge funds, as well as any other type of private fund that relies on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, which exclude from the definition of "investment company" issuers whose outstanding securities are beneficially owned by not more than 100 investors or issuers whose outstanding securities are beneficially owned only by "qualified purchasers."

Applicability to Offshore Funds is Unclear

It is unclear whether the Transparency Act, as currently proposed, applies only to funds organized in the U.S. or whether it also applies to offshore funds.

Registration and Disclosure Required for Funds with \$50 Million

The Transparency Act would transform the current Section 3(c)(1) and Section 3(c)(7) exceptions into "exemptions" from registration, so 3(c)(1) and 3(c)(7) funds would no longer be excepted from the definition of "investment company" but would instead be investment companies that are exempted from the Investment Company Act's requirements. Sections 3(c)(1) and 3(c)(7) would become new Sections 6(a)(6) and 6(a)(7) of the Investment Company Act. Funds with under \$50 million in assets would not be affected and would have no registration or filing requirements. Funds with \$50 million or more in assets, however, would be required to meet the following requirements in order to maintain their exemption from the requirements of the Investment Company Act that apply to registered investment companies (such as mutual funds):

1. Register with the SEC.
2. Maintain such books and records as the SEC may require.
3. Cooperate with any request by the SEC for information or examination.
4. File an information form with the SEC electronically, at least once per year, which would include:
 - (a) the name and address of (i) each individual who is a beneficial owner¹ of the fund (as explained below, this is intended to mean the fund managers who are owners, and not the investors in the fund); (ii) any company with an ownership interest in the fund; and (iii) the fund's primary accountant and primary broker;
 - (b) an explanation of the structure of ownership interests in the fund;
 - (c) information on any affiliation that the fund has with another financial institution;
 - (d) a statement of any minimum investment commitment required of an investor;
 - (e) the total number of investors in the fund; and
 - (f) the current value of the assets of the fund and any assets under management by the fund.

Information Disclosed Will Be Publicly Available

Even though a number of commentators have questioned the need to make the above-described information concerning a fund available to the public (as opposed to making such information available only to the SEC and other regulators), the bill makes clear that the fund's information form will be made available to the public in an electronic searchable format.

Need for Fund Managers to Register as Investment Advisers is Unclear

It is unclear whether the bill is intended to require managers of funds with at least \$50 million in assets to register as investment advisers under the Investment Advisers Act of 1940 (the "**Advisers Act**").

Currently, investment advisers (including advisers to funds) with \$30 million in assets under management are required to register under the Advisers Act unless exempted under such the Advisers Act. (Advisers with \$25 million - \$30 million in assets under management can choose between state and federal registration, unless exempted). Many hedge fund managers and most private equity fund managers rely on an exemption under Advisers Act Section 203(b)(3) for advisers: (i) who have fewer than 15 clients (with each fund counted as one client); (ii) who do not advise a registered investment company (such as a mutual fund); and (iii) who do not publicly advertise (or "hold themselves out to the public" as advisers).

¹ Although the Transparency Act requires the names of the beneficial owners of the fund to be disclosed, the bill's sponsors subsequently issued a statement clarifying that the bill does not require disclosure of clients who merely invest in the fund, but only requires disclosure of fund owners who profit from the fees generated in operating the fund.

Since the Transparency Act would require "registration" under the Investment Company Act of funds with \$50 million in assets, it is unclear whether managers of such funds could continue to rely on the Section 203(b)(3) exemption since they would now be managing funds that are investment companies registered under the Investment Company Act. Presumably, even if registration as an investment adviser is not required, the books and records requirements will be similar to those for registered advisers.

In 2004, the SEC had adopted a rule that required advisers, in counting clients for the under 15-client exemption, to count as clients the investors in the funds that the advisers managed, which caused most hedge fund managers to register as advisers. The SEC rule, however, provided that advisers could still count as a single client funds with at least a two year lock-up period. Since private equity funds have multi-year lock-ups, most private equity fund managers were not required to register under the SEC's rule. Managers of hedge funds with two-year lock-ups also avoided registration. The SEC's rule was vacated in 2006 in its entirety by the U.S. Court of Appeals in *Goldstein v. SEC*. The Transparency Act, as currently drafted, does not distinguish between private funds based on lock-up periods or any other criteria.

Anti-Money Laundering Requirements

All funds that rely on Sections 3(c)(1) or 3(c)(7), including funds with under \$50 million in assets, would be obligated to establish an anti-money laundering program and report suspicious activity. The Transparency Act would require the Treasury Secretary, in consultation with the SEC, to establish a rule to carry out the anti-money laundering obligations, which would require exempted investment companies to use "risk-based" due diligence policies, procedures, and controls that are reasonably designed to ascertain the identity of and evaluate any foreign person that supplies, or plans to supply, funds to be invested. The bill notes that the Treasury's rules "may incorporate elements" of anti-money laundering regulations that Treasury had initially proposed in 2002 but were never implemented. As those proposed 2002 rules included an exception for funds with a two-year lock-up, the Transparency Act's reference to the 2002 rules suggests that funds with a long lock-up may not be subject to the anti-money laundering requirements. (Such an exception would make sense, as funds with a long lock-up would not be useful to money launderers.)

New "Look-Through" of 10% Owners of Qualified Purchaser Funds

Apart from the registration requirements, the Transparency Act changes the current requirements for funds relying on Section 3(c)(7) of the Investment Company Act. Currently, in determining whether an investor in a Section 3(c)(7) fund is a qualified purchaser, the fund is not required to "look through" any investors that are entities to see whether the underlying owners of the entity are themselves qualified purchasers (as long as the investing entity was not "formed for the purpose" of investing in the fund). Under the Transparency Act, however, a qualified purchaser fund would have to look through any entity that (i) owns 10% or more of the outstanding voting securities of the fund and (ii) is itself an investment fund that relies on the 100-investor or qualified purchaser exemption, in order to determine if the underlying owners of the investing entity are themselves qualified purchasers. (This 10% owner "look-through" currently only applies to funds that rely on the 100-investor limitation under Section 3(c)(1)). The main effect of this change would be to limit the ability of a fund-of-funds that relies on the 100-investor limitation from owning 10% of a qualified purchaser fund.

Implementation Date

The Transparency Act provides that the SEC, within 180 days after enactment of the Act, shall issue such forms and guidance as are necessary to carry out the Act. The SEC is also given rulemaking authority to carry out the Act. Similarly, the Treasury Secretary's final anti-money laundering rules are required within 180 days after enactment of the Act. Presumably, the rules implementing the Act would give funds at least a few months to prepare before the Act's requirements took effect.

B. Hedge Fund Adviser Registration Act of 2009

On January 27, 2009, Representatives Michael Castle (R-DE) and Michael Capuano (D-MA) introduced a bill in the House of Representatives entitled the "Hedge Fund Adviser Registration Act of 2009" (the "**Adviser Registration Act**") that would amend the Advisers Act by simply deleting the Section 203(b)(3) exemption from registration explained above. Unlike the SEC's proposed rule in 2006 that amended the Section 203(b)(3) exemption but excepted managers of funds with a two-year lock-up, the Adviser Registration Act contains no exceptions at all.

Thus, under the Adviser Registration Act, the manager of certain funds would be required to register with the SEC as an investment adviser, regardless of how many clients the fund manager has or the length of the fund's lock-up period. Accordingly, like the Transparency Act, the Adviser Registration Act would apply to both private equity fund as well as hedge fund managers, in addition to investment advisers to any other type of private fund who rely on the Section 203(b)(3) exception.

C. Hedge Fund Study Act

On January 27, 2009, Representative Michael Castle also re-introduced a bill in the House of Representatives entitled the "Hedge Fund Study Act" (the "**Study Act**"). The Study Act was first introduced in 2006, and was passed by the House of Representatives, but no further action was taken by the Senate. The Study Act would require the President's Working Group on Financial Markets to conduct a study on the hedge fund industry and submit a report with recommendations that would include:

1. any proposed legislation relating to appropriate disclosure requirements for hedge funds;
2. the type of information hedge funds should disclose to regulators and to the public;
3. any efforts the hedge fund industry or regulators of financial institutions should undertake to improve practices or provide examples of successful industry initiatives; and
4. any oversight responsibilities that members of the President's Working Group should have over the hedge fund industry, and the degree and scope of such oversight.

D. Pension Security Act of 2009

Another bill introduced by Representative Michael Castle in the House of Representatives that, if passed, would have an effect on hedge funds and private equity funds is the "Pension Security Act of 2009" (the "**Pension Act**"). The Pension Act would amend the Employee Retirement Income Security Act of 1974 and require that defined benefit pension plans identify each "hedge

fund" in which amounts held for investment under the plan are invested, and disclose the amount invested in each "hedge fund." Although the Pension Act specifically uses the term "hedge fund," it defines "hedge fund" broadly to include any "unregistered investment pool" permitted under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. Thus, the Pension Act requires disclosure not only of investments in hedge funds, but also in private equity funds and other private funds relying on the 3(c)(1) or 3(c)(7) exceptions.

E. For Additional Information

Please feel free to contact us if you would like to discuss any aspect of the proposed legislation, including actions that fund managers may consider taking in anticipation of the legislation being enacted.

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For further information on this client alert or Orrick's hedge fund or private equity fund practice, please refer to the list below:

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