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Regulating Private Funds and Their Investment Advisers: A Summary of Recently Proposed Legislation

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Increased Regulation of Private Funds Proposed

Members of both the United States Senate and the House of Representatives have introduced legislation over the last two weeks that, if enacted, would greatly increase the regulatory oversight of hedge, private equity and venture capital funds and their investment advisers. Although the stated objective of the proposed legislation is to regulate the hedge fund industry, as currently drafted most of the proposed legislation also applies to private equity and venture capital funds, as well as their respective investment advisers.

We discuss each of the proposed bills below.

The Hedge Fund Transparency Act

On January 29, 2009, Senators Chuck Grassley (R-Iowa) and Carl Levin (D-Mich) introduced the "*Hedge Fund Transparency Act*."[1] In his introductory statement regarding the Transparency Act, Senator Levin noted that the Act was purposefully drafted to apply to hedge, private equity, and venture capital funds in order to discourage "future claims by parties that they are outside the definitions and thus outside the SEC's authority."[2]

Currently, most private funds are not required to register with the SEC because they are exempt from the Investment Company Act's definition of an "investment company." Private funds generally rely on either the exemption provided by Section 3(c)(1) or the exemption provided by Section 3(c)(7). Section 3(c)(1) exempts as an "investment company" any fund with no more than 100 beneficial owners. Section 3(c)(7) exempts as an "investment company" any fund exclusively owned by "qualified purchasers."[3] Both Sections prohibit a fund claiming the exemption from engaging in a public offering.

The Transparency Act would move Section 3(c)(1) and 3(c)(7) to Section 6(a)(6) and 6(a)(7) of the Investment Company Act. As a result, private funds operating in compliance with current Section 3(c)(1) or 3(c)(7) would be "investment companies" under the Act, but exempt from its provisions under Section 6.

Funds with assets, or managing assets of $50 million or more would be required to "register" with the SEC in order to claim an exemption under Section 6(a)(6) or 6(a)(7). In addition, these larger funds would be required to maintain certain books and records as prescribed by the SEC, and cooperate with the SEC with information requests or in connection with an SEC examination. Finally, they would be required to electronically file with the SEC, at least annually, a publicly available information form providing:

1. the name and current address of:

a. each natural person who is a beneficial owner of the fund;

b. any company with an ownership interest in the fund; and

c. the primary accountant and primary broker used by the fund;

3. an explanation of the structure of ownership interests in the fund;

4. information on any affiliation the fund has with another financial institution;

5. the total number of, and minimum investment commitment required by, investors; and

6. the current value of the assets and the assets under management by the fund.

The Transparency Act mandates that funds exempted from the Investment Company Act in reliance on Section 6(a)(6) or Section 6(a)(7) (formerly Section 3(c)(1) and Section 3(c)(7)) must establish an anti-money-laundering program and report suspicious transactions.

If taken up in Committee, the Act will likely be subject to revision clarifying at minimum legislative intent. For instance, late last week Senators Grassley and Levin issued a joint press release stating that the Transparency Act does not require the disclosure of *all* investors, but only those investors who profit from the fees generated by the fund's operations.[4] In its current form, however, the Act would likely be interpreted to require the disclosure of all investors or their respective beneficial owners. We note that the Senators have not addressed whether the Act is intended to require investment advisers to the newly characterized "investment companies" to register with the SEC which, under current law, would be the result.

The Transparency Act has been referred to the Senate Committee on Banking, Housing and Urban Affairs for consideration.

The Hedge Fund Adviser Registration Act of 2009

In the House, Representatives Michael Castle (R-Del) and Michael Capuano (D-Mass) introduced the "*Hedge Fund Adviser Registration Act of 2009*" on January 27, 2009.[5] Although the proposed legislation's title references hedge fund investment advisers, the Registration Act would affect investment advisers to private equity and venture capital funds as well.

The Registration Act would strike Section 203(b)(3) of the Investment Advisers Act. Section 203(b)(3) operates as a "private adviser" exemption by exempting from mandatory SEC registration any investment adviser who (i) has had fewer than fifteen clients during the preceding twelve months, (ii) does not advise registered investment companies or regulated business development companies, and (iii) does not hold itself out to the public as an investment adviser.

A significant number of investment advisers to hedge, private equity and venture capital funds currently are not registered with the SEC in reliance upon Section 203(b)(3). Eliminating the "private adviser" exemption would require them to register with the SEC as investment advisers. As registered investment advisers, their activities would be subject to SEC oversight. They would also have to comply with the extensive regulatory requirements imposed upon registered investment advisers by the Investment Advisers Act and the Rules adopted thereunder. For instance, registered investment advisers must comply with provisions relating to record keeping, compliance programs, advertising and marketing, solicitation arrangements and annual disclosures.

The Registration Act has been referred to the House Committee on Financial Services.

The Pension Security Act of 2009

Representative Castle also proposed the "*Pension Security Act of 2009*" on January 27, 2009.[6] The Pension Security Act would amend the Employee Retirement Income Security Act (ERISA) to require that each defined benefit pension plan's annual report disclose the plan's investments in hedge funds. Specifically, the Pension Security Act requires that a separate schedule to the annual report list each hedge fund invested in by the plan, and the amount invested, as of the end of the plan year covered by the annual report.

Significantly, the Pension Security Act's definition of "hedge fund" would include most private equity and venture capital funds, in addition to hedge funds. A "hedge fund" would mean a 3(c)(1) or 3(c)(7) fund (described above) offering its securities to investors in reliance upon the private placement exemptions provided by Section 4(2) of the Securities Act, or Rule 506 of Regulation D, adopted under the Securities Act.

The Pension Security Act has been referred to the House Committee on Education and Labor.

The Hedge Fund Study Act

Together with the Pension Security Act, Representative Castle introduced the "*Hedge Fund Study Act*."[7] The Hedge Fund Study Act directs the President's Working Group on Financial Markets (the "PWG") to conduct a study of the hedge fund industry, including:

1. the changing nature of hedge funds and what characteristics define a hedge fund;
2. the growth of hedge funds within financial markets;
3. the growth of pension funds investing in hedge funds;
4. whether hedge fund investors can adequately protect themselves from hedge fund investment risks;
5. whether hedge fund leverage is effectively constrained; and
6. the investor and market risk posed by hedge funds.

The Act requires that within 180 days of its enactment, the PWG present its findings to the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs. The Act also requires, among other items, that the PWG present to the Committees proposed legislation concerning hedge fund disclosure to regulators and the public, and recommendations regarding degree and scope of oversight by the Treasury Department, Federal Reserve System, SEC and CFTC over the hedge fund industry.

Conclusion

Given the current economic and political climate, we believe that private funds and their investment advisers should be prepared for additional regulation, although it is still too early to determine what form the regulation will take.

We will be monitoring the legislative progress of the Hedge Fund Transparency Act, the Hedge Fund Adviser Registration Act, the Pension Security Act, and the Hedge Fund Study Act, and will update you on any significant developments. If you have questions regarding the proposed legislation, please contact a member of the Private Equity Fund Group at Morrison & Foerster LLP.

Footnotes

[1] The proposed legislation is available at: http://thomas.loc.gov/home/gpoxmlc111/s344_is.xml
[2] Senator Levin's statement is available at:http://frwebgate.access.gpo.gov/cgi-bin/getpage.cgi?position=all&page=S1060&dbname=2009_record
[3] A "qualified purchaser" includes a natural person with at least $5 million in investments, or a company with at least $25 million in investments, subject to certain exceptions.
[4] The joint press release is available at: http://levin.senate.gov/newsroom/release.cfm?id=307821
[5] The proposed legislation is available at: http://thomas.loc.gov/home/gpoxmlc111/h711_ih.xml
[6] The proposed legislation is available at: http://thomas.loc.gov/home/gpoxmlc111/h712_ih.xml
[7] The proposed legislation is available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h713ih.txt.pdf