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SENATE SEEKS GREATER TRANSPARENCY FOR PRIVATE EQUITY FUNDS

On January 29, 2009, Senators Charles Grassley (R-Iowa), and Carl Levin (D-Michigan) introduced a new bill into the Senate (S. 344)[1] entitled the Hedge Fund Transparency Act of 2009 (the **"Bill"**) in an effort to "close the loophole in securities law that allows hedge funds to operate under a cloak of secrecy." Notwithstanding the actual name of the Bill, the overarching intent of the Bill is to regulate all private funds, including hedge funds, private equity funds and venture funds (collectively, **"Private Funds"**).

If passed in its current form, the Bill would effectively eliminate two commonly used exceptions to the definition of an "investment company" under the Investment Company Act of 1940 (the **"Investment Company Act"**). These exceptions allow certain Private Funds to avoid registering with the Securities and Exchange Commission (the **"SEC"**) and, further, exempt such Private Funds from complying with certain regulatory requirements of the Investment Company Act. In addition, the Bill would ultimately require certain Private Funds to, among other things, reveal the names and addresses of their investors and the value of the assets under management.

Summary of the Bill's Impact

- The two exemptions most commonly used by Private Funds to avoid registering as an "investment company" under the Investment Company Act would be effectively removed.
- Private Funds with assets of $50 million or more would be required to register with the SEC and file an annual form divulging highly-sensitive proprietary information, including, but not limited to, the name and address of investors and an explanation of the ownership and investment structure of the Private Fund.
- Private Funds with assets of less than $50 million that are still exempted from the definition of an "investment company" would be required to establish anti-money laundering programs, report suspicious behavior, and comply with record producing requests under the USA PATRIOT Act.
- Managers of Private Funds would indirectly be required to register with the SEC as an investment advisor because of the reclassification of certain Private Funds as "investment companies."
- The language of the Bill is likely to change, because the current language of the Bill is in conflict with the stated intent of the sponsoring Senators.
- If passed in its current form, the Bill would create increased regulatory scrutiny and increased compliance costs for Private Funds.

Background

The Bill is essentially the same legislation that Senator Grassley proposed in 2007, which garnered little support and for which there was not "much of an appetite" according to Grassley. However, the times they are a changing and due to the current global financial crisis and recent scandals involving hedge funds, the Secretary of Treasury, Timothy Geithner, and the Chairman of the SEC, Mary Schapiro, in addition to Congress, have recently called for increased regulation of hedge funds. According to Senator Grassley, "[a] major cause of the current crisis is a lack of transparency. The wizards on Wall Street figured out a million clever ways to avoid the transparency sought by the securities regulations adopted during the 1930s.

1 *The entire text of The Hedge Fund Transparency Act of 2009 may be viewed at http://grassley.senate.gov/private/upload/01292009-2.pdf*

Instead of the free flow of reliable information that markets need to function properly, today we have confusion and uncertainty fueling an economic crisis." Adding that "[i]f the events of the last year have taught us anything, it's that we need to regulate firms that are big enough to destabilize our economy if they fail. It's time to subject financial heavyweights . . . to federal regulation and oversight to protect our investors, markets, and financial system."

The Bill

Today, under the Investment Company Act, an "investment company" must register with the SEC and comply with certain of the regulatory requirements promulgated thereunder. Currently, Private Funds are able to claim that they are exempted from the definition of an "investment company" under the Investment Company Act if they are either (a) owned by no more than 100 beneficial owners (Section 3(c)(1)) or (b) exclusively owned by "qualified purchasers" (Section 3(c)(1)).

The Bill would remove these two exceptions from the definition of an "investment company" in Section 3 and relocate them in new Sections 6(a)(6) and 6(a)(7). By removing these exemptions from Section 3, Private Funds that have relied on these exemptions in the past would no longer be afforded such a luxury and would be classified as "investment companies."

Under the Bill, a Private Fund with assets of $50 million or more would be required to:

- Register with the SEC;
- File an information form with the SEC electronically, at least once in every twelve month period, that is made freely available to the public in an electronic, searchable format, that includes:
  - the name and current address of each natural person who is a beneficial owner of the investment company;
  - the name and current address of any company with an ownership interest in the investment company;
  - the name and current address of the primary accountant and primary broker used by the investment company;
  - an explanation of the structure of ownership interests in the investment company;
  - information on any affiliation that the investment company has with another financial institution;
  - a statement of any minimum investment commitment required of a limited partner, member, or other investor;
  - the total number of any limited partners, members, or other investors;
  - the current value of the assets of the investment company; and
  - the current value of any assets under management by the investment company.
- Maintain such books and records as the SEC may require; and
- Cooperate with any request for information or examination by the SEC.

On the other hand, a Private Fund would not be required to comply with the new regulatory requirements if the Private Fund has less than $50 million in assets under management and qualifies for an exemption under new Section 6(a)(6) or 6(a)(7) (an **"Exempted Private Fund"**). However, in an effort to "safeguard against the financing of terrorist organizations and money laundering", an Exempted Private Fund would still be required to establish anti-money laundering programs and to report suspicious transactions. Once the Bill is enacted, the Secretary of Treasury would have 180 days to create a rule setting forth the policies, procedures, and controls for such anti-money laundering programs.

In addition, an Exempted Private Fund would also have to comply with the same requirements as other financial institutions for producing records requested by a federal regulator under the USA PATRIOT Act.

Apart from the Private Fund itself, the Bill indirectly requires a manager of a Private Fund to register with the SEC as an investment advisor because of the reclassification of certain Private Funds as "investment companies." Currently, a Private Fund manager may generally claim exemption from registration as an investment advisor under Section 302(b)(3) of the Advisors Act if the Private Fund manager, during the preceding twelve (12) month period, (a) had fewer than fifteen (15) clients, (b) did not hold himself out to the public as an investment advisor, and (c) did not act as an investment advisor to any registered investment company. If a Private Fund is ultimately reclassified as an "investment company," a Private Fund manager would fail part (c) of the exemption and, accordingly, no longer be able to claim an exemption from registration.

Expect Changes to the Bill

Although the Bill is less than one-month old, Senators Grassley and Levin have already had to issue a press release to clarify the intent of the Bill. Specifically, there is a growing concern that the Bill would require a Private Fund with assets of $50 million or more to disclose the names and addresses of all of its investors. Even though the current language appears to call for such disclosure, the Senators, in a February 5, 2009 press release[2], rejected this interpretation. According to the Senators, the Bill "does not require the disclosure of hedge fund clients who merely invest in the fund. Instead, the bill requires disclosure of a hedge fund's beneficial owners, who profit from the fees generated in operating the fund . . ." and, therefore, "any interpretation or characterization of our bill as requiring hedge funds to disclose their clients'

2 *The February 5, 2009 press release may be viewed at http://levin.senate.gov/newsroom/release.cfm?id=307821.*

names is incorrect." Because the Senators' intent appears to conflict with the current language of the Bill, it is likely the Bill will need to be re-written to eliminate this and any other possible ambiguity that may arise.

Implications

Private Funds can expect to face increased regulatory scrutiny and increased compliance costs if the Bill is ultimately put into law. Unless the Bill is rewritten as alluded to above, Private Funds may also have to deal with the negative repercussions that are likely to result from publishing the names of its investors, such as the loss of key investors who wish to keep their identity and investments out of the watchful eye of the public at large. In addition, Private Funds must also prepare for the possibility that sensitive proprietary information like investment and acquisition strategies may be divulged to their competitors if forced to disclose information that was otherwise previously kept confidential.

It is important to note that the Bill has not yet been passed by the Senate. However, with the heightened interest in Congress, the White House, and the SEC to regulate Private Funds, the passage of the Bill, or the passage of other similar legislation seeking greater transparency of Private Funds, is quite possible in the near future.

We will continue to monitor the progress of the Bill and any other legislation that affects our Private Fund clients.

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