# LEGISLATION TO REGULATE HEDGE FUNDS FILED; BILLS WOULD ALSO APPLY TO PRIVATE EQUITY, VENTURE CAPITAL

Beginning what is widely anticipated to be a significant Congress for the financial services industry, the first bills to regulate private investment funds, including hedge funds, have now been filed. On January 29, 2009, Senators Chuck Grassley (R-IA) and Carl Levin (D-MI) introduced the "Hedge Fund Transparency Act of 2009" (S. 344). The bill was referred to the US Senate Committee on Banking, Housing, and Urban Affairs on the same day. Meanwhile, in the House, Representatives Michael Capuano (D-MA) and Michael Castle (R-DE) have filed their own "Hedge Fund Adviser Registration Act of 2009" (H.R. 711), which has been referred to the Financial Services Committee. Both bills would make sweeping changes to existing practices, affecting not only hedge funds but also private equity funds, venture capital funds, and other participants in the financial services industry.

## GRASSLEY-LEVIN BILL SUMMARY

In general, investment funds that are, or hold themselves out as being in the business of investing or trading in securities are defined as "investment companies" under the Investment Company Act of 1940, as amended (the Investment Company Act), and are required to register with the US Securities and Exchange Commission (SEC). Commonly called "mutual funds," investment companies are subject to an extensive regulatory scheme and are overseen and periodically inspected by the SEC.

Most hedge funds and other types of private investment funds operate pursuant to exclusions from the definition of an "investment company" under sections 3(c)(1) and 3(c)(7) of the Investment Company Act. In brief, under these exclusions, a pooled investment vehicle will not be deemed an "investment company" if:

- It is does not have more than 100 beneficial owners of its outstanding securities and does not make (or propose to make) a public offering (a 3(c)(1) Fund); or
- It is owned exclusively by certain high net-worth and institutional investors known as "Qualified Purchasers," as defined in the Investment Company Act, and does not make (or propose to make) a public offering (a 3(c)(7) Fund).

The Grassley-Levin bill would remove Sections 3(c)(1) and 3(c)(7) from the Investment Company Act. Thus, funds that were previously exempted from SEC registration by these provisions of the Investment Company Act would now be deemed "investment companies."

**Brussels**
+32 (0)2 290 7800

**Denver**
+1 303.863.1000

**London**
+44 (0)20 7786 6100

**Los Angeles**
+1 213.243.4000

**New York**
+1 212.715.1000

**Northern Virginia**
+1 703.720.7000

**San Francisco**
+1 415.356.3000

**Washington, DC**
+1 202.942.5000

Nonetheless, such funds would not automatically become subject to the full regulatory scheme that applies to mutual funds. Rather, the Grassley-Levin bill creates a sort of "lite" registration category by incorporating the criteria currently set forth in Sections 3(c)(1) and 3(c)(7) into conditional exemptions from the remainder of the Investment Company Act in new Sections 6(a)(6) and 6(a)(7). Where a fund subject to new Sections 6(a)(6) or 6(a)(7) has "assets, or assets under management" of US$50 million or more,[1] it would have to meet several requirements in order to maintain its exemption. These requirements include:

- Registering with the SEC.
- Maintaining books and records required by the SEC.
- Cooperating with any SEC requests for information or examination.
- Filing a yearly information form with the SEC, which would be made publicly available. The form would have to include:
    - — Names and addresses of each of the fund's owners (whether individuals or legal entities).
    - — An explanation of the fund's ownership structure.
    - — Information on affiliations with other financial institutions.
    - — The name and address of the fund's primary accountant and its primary broker.
    - — A statement of any minimum investment commitments required.
    - — The total number of its investors.
    - — The current value of the fund's assets and assets under management.

In addition, funds meeting the exemptions under new Sections 6(a)(6) or 6(a)(7) would be required to establish anti-money laundering (AML) programs and report suspicious transactions under the Bank Secrecy Act.[2]

A previous SEC rule was aimed at registration of hedge fund managers, but was invalidated by the DC Circuit in 2006.[3] The Grassley-Levin bill would require registration of funds rather than their managers, principally for the purposes of providing the SEC with certain base information regarding each fund and clear authority to request more information, and subjecting the manager and its funds to uniform record-keeping and AML requirements. Making such information publicly available would be particularly problematic for private funds and their managers, especially the identification of fund investors. It is not apparent that any public interest would be served by publicizing the names and home addresses of fund investors. It is possible that the draft may have been intended to require disclosure of beneficial owners of fund managers rather than funds themselves. The legislation may reflect a lack of information as to how private funds are structured and managed.[4] In addition, certain fund managers may wish to maintain the confidentiality of asset figures for funds that are not already required to be reported.

## CAPUANO-CASTLE BILL SUMMARY

The Capuano-Castle bill is quite short, but would have enormous implications. At present, Section 203(b)(3) of the Investment Advisers Act of 1940, as amended (the Advisers Act), provides an exemption from registration with the SEC for investment advisers that have had fewer than 15 clients in the preceding 12-month period and who do not hold themselves out to the public as investment advisers or act as advisers to mutual funds. Under the Advisers Act and SEC rules, a legal entity such as a limited partnership or corporation is deemed to be a single client. Thus, under this exemption, many private fund managers are not required to register with the SEC because they manage a limited number of funds. The exemption reflects Congress' view

1 The bill does not specify what is meant by "assets" on the one hand, and "assets under management" on the other.

2 31U.S.C. §5318(g) and (h). The bill requires the Secretary of the US Department of the Treasury to adopt rules implementing these requirements after consultations with the SEC and Commodity Futures Trading Commission. Nonetheless, the proposed legislation would be self executing: if Treasury failed to issue such regulations, Funds would still be required to adopt anti-money laundering programs and report suspicious transactions.

3 *Goldstein* v. *SEC*, 451 F.3d 873 (D.C. Cir. 2006).

4 We note, however, that mutual funds are required to publicly report the name, address, and percentage ownership interest of each person who owns of record or is known by the mutual fund to own beneficially 5% or more of any class of its outstanding equity securities.

that advisers with a limited number of clients should not be subject to registration.

The Hedge Fund Adviser Registration Act of 2009 would strike Section 203(b)(3) of the Advisers Act, removing this so-called "private adviser" exemption entirely. If the Capuano-Castle bill were enacted as presently written, the SEC may be flooded with new registration applications, particularly from hedge fund, private equity fund, and venture capital fund managers.

## OUTLOOK

As might be expected from initial drafts, the bills each raise serious issues and we anticipate revisions or alternative proposals. Nonetheless, the bills do provide a first look at some of the topics being discussed among members of Congress and their staff. Interested observers may wish to take note of the following aspects of the upcoming debate:

- Neither Senator Grassley nor Senator Levin are members of the Committee on Banking, Housing, and Urban Affairs, which has jurisdiction over financial matters. The members of that Committee are known to be working on legislation dealing with the financial crisis, and are expected to take up regulation of private funds. Nonetheless, both Senators are well-respected and have demonstrated commitment to ensuring that their views on hedge funds are heard. It is likely that at least some elements of their proposal (such as the AML provisions) will progress through the legislative process.
- While hedge funds appear to have been the focus of media and regulatory attention, neither bill makes exceptions for private equity funds, venture capital funds, or the like. Indeed, Senator Levin, in introducing his bill, stated that "a wide variety of entities invoke [Investment Company Act Sections 3(c)(1) and (7)] to avoid … SEC oversight, and they refer to themselves by a wide variety of terms–hedge funds, private equity funds, venture capitalists, small investment banks, and so forth," and made clear that no exceptions were contemplated for such entities.

As the 111th Congress progresses, asset managers should be attentive to the progress of these bills in the legislative process, as well as others that are expected to surface. They may also wish to examine their current operations and determine whether and how potential legislation could affect them. For example, hedge fund managers who have not already voluntarily adopted AML procedures as a matter of "sound practice" may wish to revisit adoption at this time.

---

*We hope that you have found this client advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:*

**Michael F. Griffin**
+1 212.715.1136
Michael.Griffin@aporter.com

**Robert E. Holton**
+1 212.715.1137
Robert.Holton@aporter.com

**Richard P. Swanson**
+1 212.715.1179
Richard.Swanson@aporter.com

**Andrew Shipe**
+1 202.942.5049
Andrew.Shipe@aporter.com