Proposed Hedge Fund Transparency Act

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On January 29, 2009, Senators Charles Grassley, R-Iowa and Carl Levin, D-Michigan introduced to the Senate the Hedge Fund Transparency Act (the "HFTA"). The stated purpose of the bill is to subject hedge funds to limited regulation by the U.S. Securities and Exchange Commission (the "SEC"). However, notwithstanding its title, the HFTA is not limited to hedge funds. If the HFTA is enacted as proposed, any entity with $50 million or more in assets that currently relies on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act") to avoid registration as an investment company (“private investment companies”) would be required to register with the SEC and comply with certain other requirements specified in the HFTA. While the HFTA would subject private investment companies to significantly less extensive regulation than the 1940 Act imposes on other registered investment companies, if the HFTA is enacted as proposed, private investment companies’ regulatory obligations would increase substantially.

Proposed Framework and Disclosure and Compliance Obligations

Currently, under Section 3(c)(1), entities that have no more than 100 beneficial owners and that are not publicly offering their securities are exempt in almost all respects from the requirements of the 1940 Act. Similarly, under Section 3(c)(7), entities whose securities are sold exclusively to "qualified purchasers" and are not publicly offered are also exempt in almost all respects from the requirements of the 1940 Act.

The HFTA would replace both of these Sections with proposed Sections 6(a)(6) and 6(a)(7) of the 1940 Act. The basic requirements for these exemptions are the same as those for current Sections 3(c)(1) and 3(c)(7), respectively, except in two respects. First, proposed Section 6(a)(7) includes a new "look through" provision, under which the issuer would be required to "look through" each investment company and private investment company that holds 10 percent or more of the voting securities of the issuer in order to determine whether all of the issuer's beneficial owners are qualified purchasers. Currently, entities relying on Section 3(c)(1) are subject to this requirement, but not entities relying on Section 3(c)(7).

More importantly, private investment companies that have $50 million or more in assets would be required to register with the SEC and comply with other disclosure and regulatory requirements stated in proposed Section 6(g) of the 1940 Act. Entities complying with these requirements would be exempt from the other requirements of the 1940 Act. Entities that fail to comply with these requirements would be fully subject to

the regulatory requirements of the 1940 Act, including governance requirements, limits on their capital structure and the use of leverage, and restrictions on transactions with affiliates.

Under the HFTA, private investment companies with assets of $50 million or more would be required to (1) register with the SEC; (2) file at least annually an information form with the SEC that will be publicly available; (3) maintain such books and records as the SEC may prescribe; and (4) cooperate with any request for information or examination by the SEC. The HFTA does not specify what information would be required to be included in the registration form.

The information form required by the HFTA would be electronically filed at such time as the SEC requires, but at least annually and would include the following information:

1) The name and current address of each individual who is a beneficial owner of the private investment company (on February 5, 2009 Senators Grassley and Levin issued a joint statement in which they state that this provision was not intended to require public disclosure of investors' names. "The bill requires disclosure of a hedge fund's beneficial owners, who profit from the fees generated in operating the fund," and not the names of outside clients);

2) The name and current address of any company with an ownership interest in the private investment company;

3) The name and the current address of the private investment company's primary accountant and primary broker;

4) An explanation of the structure of ownership interests in the private investment company;

5) Information on any affiliation with another financial institution;

6) A statement of any minimum investment commitment required of a limited partner, member or investor;

7) The total number of limited partners, members or other investors in the private investment company; and

8) The current value of the assets of the investment company.

The HFTA would also require private investment companies, regardless of their size, to adopt an anti-money laundering ("AML") program within one year after the enactment of the HFTA. Within 180 days of the enactment of the HFTA, the Secretary of the Treasury

(in consultation with the Chairman of the SEC and the Chairman of the Commodity Futures Trading Commission) would be required to issue a rule that establishes the minimum requirements for such an AML program.

The SEC would be required, within 180 days of enactment, to issue the forms and guidance to implement the HFTA. The information filed with the SEC would be made available by the SEC to the public at no cost and in an electronic, searchable format. The SEC would also have ongoing, rule-making authority in order to carry out the HFTA.

Some Implications of the Hedge Fund Transparency Act

While the name of the HFTA suggests it is aimed at hedge funds, the text does not define hedge funds or seek to limit the HFTA to hedge funds. A wide variety of other entities, including private equity funds, venture capital funds, insurance companies that issue private placement variable insurance and annuity products, finance subsidiaries and asset-backed security vehicles, currently rely on the private investment company exemptions. If the HFTA is passed as proposed, all of these entities would be subject to registration with the SEC and increased regulatory obligations. Entities in some of these businesses—for example, sponsors of finance subsidiaries or asset-backed vehicles, which are engaged in raising needed credit—are likely to question whether the proposed requirements under the HFTA are necessary or appropriate, in light of differences between their businesses and that of hedge funds.

In addition, the HFTA may sub silentio require SEC registration of investment advisers to private investment companies that rely on the proposed exemptions. Many private fund managers rely on the exemption provided by Section 203(b)(3) of the Investment Advisers Act which exempts an adviser with fewer than 15 clients from registering as long as the adviser does not hold itself out to the public as an investment adviser and does not advise an investment company registered under the 1940 Act. Since the HFTA would require private investment companies with assets of $50 million or more to register under the 1940 Act, on its face, the HFTA appears to disqualify the advisers to these private investment companies from relying on the Section 203(b)(3) exemption. Accordingly, while the HFTA does not expressly require investment advisers to private investment companies to register with the SEC, it appears that it would indirectly have that effect and, as a result, these advisers would become fully subject to the regulatory requirements of the Advisers Act. If Congress did not intend the HFTA to have this effect, then Section 203(b)(3) of the Advisers Act would need to be amended to clarify that the exemption continues to be available to advisers of funds that are registered with the SEC pursuant to the HFTA.

Finally, the HFTA raises issues as to its effect on entities organized outside the United States that have US investors. Currently, investment companies organized outside the United States are not required to register with the SEC if they comply with Section

3(c)(1) or 3(c)(7) with respect to US investors. See, e.g., Touche, Remnant & Co. (pub. avail. Aug. 27, 1984). It is unclear whether non-US entities relying on the current private investment company exemptions would continue to be exempt from regulation under the 1940 Act, or whether they would be required to comply with the registration and other requirements of the proposed exemptions and, if so, how those requirements would apply to their non-US activities and investors.

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This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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