

Summary:

- Hedge Fund Transparency Act would require 3(c)(1) and 3(c)(7) funds with more than \$50 million to register with the SEC and make annual informational filings
- Most funds would be required to implement anti-money laundering programs
- Could affect advisors' ability to collect carried interests.
- Hedge Fund Adviser Registration Act would eliminate "15 or fewer clients" exemption for fund advisors

### **Private Investment Funds and Fund Advisors May Face Stricter Registration Requirements**

Proposed legislation would increase registration requirements for private investment funds and their advisors. In January 2009, Senators Charles Grassley and Carl Levin introduced the Hedge Fund Transparency Act (the "Transparency Act"), a bill intended to expand the SEC's ability to require hedge funds and other private investment companies to register under the Investment Company Act of 1940 (the "Investment Company Act").

Most hedge funds, venture capital funds, private equity funds and other private investment funds avoid registration with the SEC by operating outside the Investment Company Act's definition of "investment company." Sections 3(c)(1) and 3(c)(7) of the Investment Company Act exclude from definition of "investment company" funds with fewer than 100 beneficial owners and funds whose investors are all "qualified purchasers." Funds operating under one of those definitional exceptions are not, under current law, "investment companies" subject to the Investment Company Act.

The Transparency Act would modify the definition of "investment company" to include funds with fewer than 100 beneficial owners and funds owned entirely by qualified purchasers. Such funds would remain exempt from most elements of the Investment Company Act under new exemptions. The new exemptions are substantially the same as the current 3(c)(1) and 3(c)(7) exceptions. However, to rely on the new exemptions, a fund with more than \$50 million in assets would be required to register with the SEC and complete annual informational reports to the SEC.

Under the proposed new exemptions, funds with \$50 million or more in assets must:

1. Register with the SEC;
2. Maintain books and records that the SEC may require;
3. Cooperate with any request by the SEC for information or examination; and
4. File an information form with the SEC electronically, at least once a year. The information form must be made freely available to the public in an electronic, searchable format, and must include:
  - a. The name and current address of each individual who is a beneficial owner of the investment fund;
  - b. The name and current address of any company with an ownership interest in the investment fund;

- c. An explanation of the structure of ownership interests in the investment fund;
- d. Information on any affiliation with another financial institution;
- e. The name and current address of the investment fund's primary accountant and primary broker;
- f. A statement of any minimum investment commitment required of a limited partner, member, or investor;
- g. The total number of any limited partners, members, or other investor; and
- h. The current value of the assets of the fund and the assets under management by the fund.

According to a press release from Senator Levin, the information report's requirement to identify all individuals and companies with an ownership interest in the investment fund is intended only to identify parties entitled to a portion of the fund's fees, not to identify all the investors in the fund.

Another change to the regulatory scheme includes the application of the beneficial owner "look-through" provisions to investors that own more than 10% of any fund relying on the revised exemptions. Currently, funds relying on the "100-investor" exception must count as beneficial owners the owners of each investor company that owns more than 10% of the fund's assets. The Transparency Act would apply this look-through to funds relying on exemptions based on the "100-investor" rule and the "qualified purchaser" rule. It is unclear what the intended purpose of this change is with respect to 3(c)(7) funds.

The Transparency Act also requires each fund relying on the revised 3(c)(1) and 3(c)(7) exemptions to establish an anti-money laundering program and report suspicious transactions. This would apply regardless of the size of the fund.

An ancillary effect of the Transparency Act would be to narrow an exemption from the investment advisor registration requirement. Currently, many fund advisors rely on the "fewer than 15 clients" exemption from SEC registration. Under Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Investment Advisers Act"), a fund advisor is exempt from registration if it advises fewer than fifteen clients during the preceding twelve month period, does not hold itself out as an advisor to the general public, and does not advise any fund registered under the Investment Company Act. Because a fund with assets of \$50 million or more would be required to register under the Investment Company Act, that fund's advisors would lose their exemption from registration under Section 203(b)(3) of the Investment Advisers Act.

The Transparency Act's changes could ripple through to funds' fee structures, as well. Typical investment funds include a carried interest provision entitling the advisor to a portion of the fund's capital gains. The Investment Advisers Act's general prohibition against carried interests does not apply to advisors exempt from registration under 203(b)(3). Therefore, by reducing the availability of the 203(b)(3) exemption, the Transparency Act could also affect a fund advisor's ability to collect its carried interest.

In addition, Congressman Michael Castle proposed the Hedge Fund Adviser Registration Act of 2009 (the "Adviser Registration Act"), which would eliminate Section 203(b)(3) from the Investment Advisers Act altogether. As noted earlier, many fund advisors take advantage of Section 203(b)(3) to avoid SEC registration by advising fewer than 15 clients and not holding themselves out to the public as investment advisors. The Adviser Registration Act would eliminate this exemption, which would mean that hedge fund advisors would be required to register regardless of how many funds they advise. This change, like those proposed under the Transparency Act, could also effect fund advisors' ability to collect their carried interests.

Passage of these bills would tighten the regulatory framework for a significant number of investment funds and investment advisors currently exempt from registration with the SEC. We will continue to monitor progress on these and other legal changes.