JONES DAY

FEBRUARY 2009

HEDGE FUND TRANSPARENCY ACT OF 2009: CONGRESS CONSIDERS EXPANSION OF INVESTMENT FUND REGULATION

On January 29, 2009, Senators Chuck Grassley (R-Iowa) and Carl Levin (D-Michigan) introduced the Hedge Fund Transparency Act of 2009 (the "HFTA," S. 334 of the 111th Congress). The bill is an attempt to address what Senators Grassley and Levin describe as a "loophole in securities law that allows hedge funds to operate under a cloak of secrecy." Notwithstanding its title, the bill would have a significant effect on not only hedge funds but also many private equity buyout funds, venture capital funds, structured finance vehicles, and some real estate funds. It proposes to replace current exceptions to the Investment Company Act of 1940 (the "Investment Company Act") commonly used by these funds with similar, but modified, exemptions, clarifying the authority of the Securities and Exchange Commission (the "SEC") to oversee these private funds. It would additionally require funds of a specific size relying on the new exemptions to register and cooperate with the SEC, maintain books and records as required by the SEC, and file annual disclosure statements that include, among other information, the identities of the funds' investors and value of fund assets. The bill also proposes requiring these funds to establish anti-money laundering programs and to report suspicious transactions, in line with requirements for financial institutions.

BACKGROUND

Senator Grassley previously submitted a bill that sought to regulate hedge fund managers by amending the Investment Advisers Act of 1940 (the "Investment Advisers Act"). The HFTA, although described by Senators Grassley and Levin as a revised version of that bill, is aimed instead at the funds themselves (rather than their managers) via the Investment Company Act. The HFTA may also have the unintended consequence of requiring advisers to some funds to register as investment advisers under the Investment Advisers Act. Senators Grassley and

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Levin state that the HFTA is in response to a 2006 decision by the U.S. Court of Appeals for the District of Columbia (commonly known as the "*Goldstein* decision") that vacated an SEC rule that would have imposed registration obligations on hedge fund managers previously exempted under the Investment Advisers Act. The HFTA would instead broadly regulate many funds that currently rely upon the exceptions in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. Senator Grassley specifically noted in his introductory statement to the HFTA that there was no appetite for this type of legislation prior to the current financial crisis.

FROM EXCEPTIONS TO EXEMPTIONS

Currently, virtually all hedge funds, private equity funds, venture capital funds, and structured finance vehicles rely upon exceptions under Section 3(c)(1) (for funds with fewer than 100 beneficial owners) or Section 3(c)(7) (for funds made up solely of "qualified purchasers") of the Investment Company Act. By replacing the current Sections 3(c)(1) and 3(c)(7) with identical text but in Sections 6(a)(6) and 6(a)(7), the HFTA would turn these exceptions from the definition of "investment company" into exemptions from certain requirements of the Investment Company Act. Although funds relying on these exemptions would continue to avoid many of the burdensome requirements placed on registered investment companies (*i.e.*, mutual funds), this change would explicitly clarify that the SEC has legislative authority to oversee and supervise these private funds. It not clear from the text of the HFTA whether all references to a "registered investment company" in the Investment Company Act will include funds relying on these new exemptions.

FOUR NEW CONDITIONS FOR EXEMPTION

The HFTA would add a new Section 6(g) to the Investment Company Act, requiring funds with assets or assets under management of $50 million or more that wish to rely on the new exemptions in Sections 6(a)(6) or 6(a)(7) to comply with four new conditions. These funds would be required to:

- Register with the SEC.
- File an annual information form with the SEC (as further described below).
- Maintain books and records as required by the SEC.
- Cooperate with any request for information or examination by the SEC.

The information form would be filed electronically at a time and in a manner as required by the SEC, but no less frequently than once every 12 months. It would be made available by the SEC to the public at no cost in an electronic, searchable format and would include the following information:

- Names and current addresses of (i) natural persons that are beneficial owners in the fund, (ii) companies with an ownership interest in the fund, and (iii) the primary accountants and primary brokers used by the fund.
- An explanation of the structure of ownership interests in the fund.
- Information on any affiliation that the fund has with another financial institution.
- A statement of any minimum investment commitment required of a limited partner, member, or other investor in the fund.
- The total number of any limited partners, members, or other investors in the fund.
- The current value of (i) the assets of the fund, and (ii) any assets under management by the fund.[1]

Disclosure of the identities of investors in funds that rely on these new exemptions would represent a sea change for these investors, who are accustomed to having their investments in Section 3(c)(1) and 3(c)(7) funds kept confidential.

ANTI-MONEY LAUNDERING COMPLIANCE OBLIGATIONS

In October 2008, the U.S. Treasury agency responsible for anti-money laundering regulation withdrew proposed anti-money laundering program requirements for unregistered

1. The text of the HFTA requires disclosure of the current value of "any assets under management by the investment company." It is not clear what is contemplated by disclosure of "assets under management" for a fund itself. It is possible that the legislators intend to require disclosure of assets under management by fund managers, rather than the funds themselves.

investment funds and investment advisers based on the conclusion that funds and advisers conduct financial transactions through financial institutions that were already subject to anti-money laundering program rules. In a provision designed to specifically undo that decision, the HFTA imposes new anti-money laundering obligations on funds relying on the new exemptions in Sections 6(a)(6) and 6(a)(7). Each fund would be required to establish an anti-money laundering compliance program and to report suspicious transactions, in line with existing requirements for financial institutions (from 31 U.S.C. 5318).

The Secretary of the Treasury, in consultation with the Chairmen of the SEC and Commodity Futures Trading Commission, has been tasked with promulgating associated rules within 180 days of the enactment of HFTA, to establish policies, procedures, and controls for these anti-money laundering obligations. These rules must include a requirement for risk-based due diligence policies, procedures, and controls that are reasonably designed to ascertain the identity of and evaluate any foreign person that supplies or plans to supply funds to be invested with the advice or assistance of the funds in question. These rules would also subject funds to the "120 hour rule," which requires institutions to provide information to federal agencies within 120 hours of receiving a request for information related to anti-money laundering compliance. The HFTA's anti-money laundering compliance obligations are required to be effective within one year of HFTA's enactment, whether or not the Secretary of the Treasury has promulgated its rules.

COMMENTARY

The HFTA, as written, raises a number of questions of application. It is not clear how this new legislation would apply to funds organized offshore, and whether the SEC's approach of not considering foreign investors in foreign organized funds for purposes of current Sections 3(c)(1) and 3(c)(7) would survive this amendment to the Investment Company Act. It is also not clear whether foreign organized funds with some U.S. investors must register under the Investment Company Act and disclose the names of all of their investors, including non-U.S. investors. Finally, it is unclear whether the exemption under Section 203(b)(3) of the Investment Advisers Act will be affected by the HFTA, given its reference to "any investment company registered under Title I of this Act." If this term encompasses funds relying on the new Section 6(a)(6) and 6(a)(7) exemptions, rather than simply those registering under Section 8 of the Investment Company Act, many fund managers would also be required to register under the Investment Advisers Act, notwithstanding their current reliance on being exempt from adviser registration because they have fewer than 15 clients.

The HFTA, in many respects, does not go as far as suggested by the recommendations for increased "Oversight of Private Pools of Capital" contained in the Group of Thirty report issued in January 2009 entitled "Financial Reform: A Framework for Financial Stability." This report was co-chaired by Paul Volcker, one of President Obama's key economic advisers and former chairman of the Federal Reserve, and its recommendations are widely cited as the blueprint for the Obama administration's future financial services regulatory reform agenda. In particular, the HFTA does not address the Group of Thirty key recommendation that "systematically significant" funds be subjected to regulation of capital, liquidity, and risk management. Senator Levin indicated in his introductory remarks that the bill "gives the SEC the authority it needs to impose additional regulatory obligations and exercise the level of oversight it sees fit over hedge funds to protect investors, other financial institutions, and the U.S. financial system as a whole."

While the current financial crisis has resulted in a significant shift in the public's confidence in our financial institutions, it is unclear what—if any—benefit will be achieved by the proposed legislation. Noting that most investors in these funds—particularly private equity buyout funds, venture capital funds, structured finance vehicles, and real estate funds—are significantly sophisticated, we have not identified any element of the HFTA that specifically addresses issues of investor confidence in our private equity markets. While we doubt that the bill will clear Congress and gain Presidential approval in its current form, we anticipate that legislators will view the HFTA as an opportunity to assert to their various constituents that Congress is taking substantive steps to tighten regulation in the financial services industry. We will continue to monitor the progress of the HFTA and any related regulations.

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