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REGISTRATION OF PRIVATE INVESTMENT FUNDS UNDER THE PROPOSED HEDGE FUND TRANSPARENCY ACT

U.S. Senator Charles Grassley (R-Iowa) may at last have his way. For the past decade or more, Senator Grassley has sought to impose regulatory oversight of hedge funds. With the current financial and political environment more conducive than ever to regulatory oversight of financial institutions and markets, on January 29, 2009, Sen. Grassley, together with Senator Carl Levin (D-Mich.), introduced the Hedge Fund Transparency Act (the Act). Nomenclature aside, the Act as currently written is not limited to hedge funds, but rather applies to any private investment fund, including private equity and venture capital funds.

The Act is a combination of new approaches layered on top of recycled past proposals to require either hedge funds (or private equity or venture capital funds) or their management firms to register with the Securities and Exchange Commissions (SEC).

What Investment Funds are Impacted?

The Act would require most private investment funds to register with the SEC and publicly disclose information about the fund and its managers, asset base, investor identities and other details. The Act would apply to *any* investment fund with at least \$50,000,000 of assets under management that is exempt from registering with the SEC as an investment company under Sections 3(c)(1) or 3(c)(7) of the '40 Act. Most private investment funds rely on one of these exemptions.¹

What Does the Act Require?

The Act would condition the availability of these exemptions to funds that do the following:

1. Register with the SEC (on a form to be prescribed by the SEC).
2. Maintain such books and records that the SEC may require.
3. Cooperate with any request by the SEC for information or examination.
4. File an information form with the SEC electronically, at least once a year. This form must be made freely available to the public in an electronic, searchable format. The form must include:
 - The name and address of each individual who is a beneficial owner of the fund.
 - The name and address of any company with an ownership interest in the fund.
 - An explanation of the structure of ownership interests in the fund.
 - Information on any affiliation the fund has with another financial institution.
 - The name and address of the fund's primary accountant and primary broker.
 - A statement of any minimum investment commitment required of an investor.
 - The total number of investors.
 - The current value of the fund's assets and the assets under the fund's management.

¹ A fund exempt under Section 3(c)(1) may have up to 100 beneficial owners while a fund exempt under Section 3(c)(7) may have up to 499 beneficial owners who are also "qualified investors" (e.g., individuals holding at least \$5,000,000, and entities holding at least \$25,000,000, in qualified investments).

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While this type of information appears targeted toward hedge funds, there is no indication in the Act or comments from its sponsors that only traditional hedge funds are to be covered by the registration and reporting requirements.

Anti-Money Laundering Programs

The Act re-introduces a previously withdrawn proposal that requires private investment funds to adopt anti-money laundering (AML) programs. AML programs are currently mandatory for most financial institutions. This part of the Act is likely to have little impact. Most private investment funds adopted AML programs in response to U.S. Treasury Department rules proposed in 2002 but ultimately withdrawn on October 30, 2008.

Will the Act Be Enacted?

Prior attempts to require registration of private investment funds or their managers have not succeeded. For example, in *Goldstein v. SEC*, the Federal Court of Appeals for the D.C. Circuit vacated the SEC's rule requiring most hedge fund advisers to register with the SEC under the Investment Advisors Act of 1940.²

Now, however, there appears to be widespread support in Congress and the SEC for some form of regulatory oversight of hedge funds. The new SEC Chair, Mary Schapiro, testified recently to Congress that she supported requiring hedge funds to register with the SEC. The new Treasury Secretary, Timothy Geithner, gave similar testimony during his confirmation proceedings. And, SEC Commissioner Luis Aguilar said in a speech made available on January 27, 2009 that Congress should give the SEC authority to regulate hedge fund advisers and derivatives.

Finally, a parade of industry professionals and members of academia in recent Congressional testimony have lent their support for regulatory oversight of hedge funds and derivative financial instruments.

Accordingly, given this broad support, and the Act's bi-partisan sponsorship, it appears inevitable that some form of SEC registration will be mandated at least for hedge funds if not other private investment funds unless the SEC narrows the Act's scope in its rule making process.

Once the Act is passed, it is currently contemplated that the SEC would have 180 days to issue forms and guidance to carry out the Act.

What are the Implications?

Many hedge fund managers are already registered as investment advisers with the SEC or a state counterpart. Most of these managers are located outside of New York and the handful of other states that do not have registration exemptions available for fund managers managing a de minimis number of funds. Accordingly, hedge fund managers already registered as investment advisers will not be as impacted by the Act and its provisions, including the ability of the SEC or state to conduct routine audits of their firms.

However, it is rare for New York-based hedge fund managers or managers of private equity or venture capital funds to be registered as investment advisers. As a result, the Act would represent a significant departure from past practice for these funds. Moreover, even registered investment advisers are not required to disclose to regulators – let alone to the public – the identities of their investors or the assets they manage. The requirement to do so could have a chilling impact on such funds' ability to raise and invest capital.

The Act will also raise compliance costs, particularly for funds whose managers are not registered investment advisers.

Finally, the SEC has long sought to have a regulatory means to gather information on how hedge funds operate. Since the Act is geared more towards information gathering than regulating operations, it should come as no surprise if operational regulations are a future by-product of the information gathered by the SEC under the Act.

² The SEC exempted from those regulations funds that required two-year capital lock-ups, essentially an attempt to carve out customary private equity and venture capital funds. While the SEC may adopt similar carve outs, there is no indication to date that the Act's sponsors or the SEC will do so.

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