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A legal update from Dechert's Financial Services Group

Proposed Hedge Fund Registration Act Falters in Senate

Summary

On May 15, 2007, Senator Chuck Grassley of Iowa, the ranking Republican member of the Finance Committee, introduced legislation that, in effect, would require investment advisers of most hedge funds and other private investment funds to register with the Securities and Exchange Commission under the Investment Advisers Act of 1940 (the "Advisers Act"), and would subject such advisers to regulation under the Advisers Act.

Senator Grassley introduced his legislation because he was concerned with what he regarded as inadequate regulation of hedge funds. The bill, known as the "Hedge Fund Registration Act of 2007," would reverse the effects of a D.C. Circuit Court of Appeals ruling in March 2006 that invalidated Rule 203(b)(3)-1 under the Advisers Act, which the SEC had promulgated in an effort to require certain hedge fund advisers to register under the Advisers Act.[1]

Senator Grassley's effort faltered when he failed to attach his bill as an amendment to S. 4, the 9/11 Commission Recommendations Bill.

Discussion

The proposed Hedge Fund Registration Act of 2007 would amend Section 203(b)(3) of the Advisers Act to exempt from registration only those investment advisers who, during the preceding 12-month period:

- had assets under management of not more than $50,000,000;
- had fewer than 15 clients (excluding shareholders, partners, or beneficial owners of business development companies who are not otherwise clients of the investment adviser);
- did not manage the assets of more than 15 investors, whether individually, in a pooled investment vehicle described in paragraphs (1) and (7) of Section 3(c) of the Investment Company Act of 1940, or otherwise;
- had not held itself out to the general public as an investment adviser (or served as an investment adviser to a registered investment company or a business development company).

Importantly, investment advisers would always be required to "look through" and count investors in pooled investment vehicles as clients for purposes of the registration requirements of the Advisers Act.

On June 8, Senator Grassley attempted to add his amendment to S. 4, the 9/11 Commission Recommendations Bill. He said that it would

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[1] *See Goldstein v. SEC*, 451 F.3d 873, D.C. Cir. (2006). In 2006, after concluding that its regulatory program was inadequate, the SEC promulgated Rule 203(b)(3) ("Rule") under the Advisers Act which provided that for purposes of Section 203(b)(3) of the Advisers Act, shareholders, limited partners, members, or beneficiaries of a pooled investment entity must be counted as "clients." *See DechertOnPoint: Court Throws Out Hedge Fund Adviser Registration Rule-What Happens Now?* http://www.dechert.com/library/FS_Update9_7-06.pdf.

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"narrow an exemption from registration for certain investment advisers." The bill manager objected, citing a backlog of pending amendments that prevented Senate debate on the matter. Senator Grassley then submitted his prepared statement into the record.

In his statement, Senator Grassley said that he was offering an amendment to S.4 that seeks to strengthen our nation's homeland security by closing a loophole in our securities laws. He asserted that there is a homeland security element to his amendment because it is important to know who is managing large sums of money for wealthy foreign investors. As an example, he pointed to a report that a Boston-based private equity firm, Overland Capital Group, Inc, is under investigation by the Internal Revenue Service and Department of Justice counterterrorism division. He said that such firms, which manage hundreds of millions of dollars for wealthy investors in total secrecy, ought to have to register with the SEC.

He noted that there have been many reports during the last few years regarding hedge funds and the market power they wield because of the large amounts of capital they invest. Grassley noted some estimates that these pooled investment vehicles constitute nearly 30% of the daily trading in U.S. financial markets. Grassley stated that Congress needs to ensure that the government knows who is running these large vehicles to ensure the security of those markets.

He said that the recent failure of Amaranth Advisers, which some commentators say showcases the gaping holes in hedge fund regulation,[2] and the increasing interest in hedge funds as investment vehicles for public pension money demonstrates that this issue affects regular investors, not just the sophisticated investors that traditionally invested in hedge funds. Grassley also said that his recent oversight of the SEC has convinced him that the Commission and the Self-Regulatory Organizations need much more information about the activities of hedge funds in order to protect the markets from institutional insider trading and other potential abuses.

In conclusion, Grassley said that his amendment was a first step in ensuring that the SEC has the needed statutory authority do what it attempted to do for the last two years. He urged his colleagues to support his amendment for the protection of investors. The future of Senator Grassley's legislative effort is uncertain.

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[2] *See* Ann Davis, "San Diego Pension Fund Sues Amaranth Advisors," *The Wall Street Journal*, March 31, 2007, at A7 (citation added). *See* Ann Davis, "Behind Amaranth, A Broken System," *The Wall Street Journal*, June 25, 2007, at C1.

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