DechertOnPoint

February 2009 / Issue 4

A legal update from Dechert's Financial Services Group

Proposed Hedge Fund Legislation Would Cover More Than Just Hedge Funds

Proposed Bill Would Require SEC Registration of All Securities-Related Investment Vehicles with $50 Million or More in Assets, Including Hedge Funds, Venture Capital Funds, Private Equity Funds, Many Real Estate Funds, and Many CDOs and CLOs

Under proposed legislation, any investment fund that trades or holds securities as a significant part of its assets will be required to register under the Investment Company Act, if it has $50 million or more in assets. The proposed bill identifies hedge funds, but its scope is much broader. In addition to hedge funds, the legislation would apply to venture capital funds, private equity funds, many real estate funds, many collateralized debt obligations ("CDOs"), collateralized loan obligations ("CLOs"), and other structured products, some larger family partnerships, and potentially many others. While the new type of registration would not impose substantive limits on investment strategy, it would require significant public disclosures, including possibly the identities of investors. Moreover, the investment adviser for these newly registered vehicles would be required to register under the Advisers Act.

On January 29, 2009, Senators Charles Grassley of Iowa and Carl Levin of Michigan introduced the "*Hedge Fund Transparency Act of 2009*" (the "Bill").[1] The Bill would effectively eliminate the *exceptions* under sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), and instead convert them into conditional *exemptions* under section 6(a) of the Investment Company Act.[2] In effect, an exception removes

[1] The Bill is available at: http://levin.senate.gov/newsroom/supporting/2009/hedgefundsbill.012909.pdf.

[2] Senator Grassley commented that the intent of the Bill was to clarify and remove any uncertainty that hedge funds were subject to regulation by the SEC and the effect of the 2006 decision by the Court of Appeals for the DC Circuit (*Goldstein v SEC, 451 F.3d 873 (D.C. Cir.2006)*). *See* Press release, dated January 23, 2009 (available at: http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=18922); *see* also *DechertOnPoint*, "Proposed Hedge Fund Registration Act Falters in Senate" dated July 2007 (Issue 18).

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an issuer from the scope of the Investment Company Act while an exemption disapplies some of the provisions of the Investment Company Act. Section 6(a) exempts certain entities otherwise meeting the definition of "investment company" from the substantive provisions of the Investment Company Act, unless otherwise provided by such statute.[3]

Privately offered investment funds relying on sections 3(c)(1) or 3(c)(7) of the Investment Company Act ("Private Funds") seeking to rely on the new exemptions must:

- in the case of certain "large" Private Funds, register with the Securities and Exchange Commission (the "SEC") and disclose specified information, including possibly information regarding investors; and
- comply with specified anti-money laundering requirements.

Private Funds would be ''exempt'' investment companies rather than ''excepted'' from the definition of investment company

Although the title of the Bill refers to "hedge funds," the Bill does not distinguish among the different entities that rely on the exceptions currently provided by sections 3(c)(1) and 3(c)(7) of the Investment Company Act. As a result, the Bill would affect not only hedge funds but also other types of privately offered funds, including venture capital funds, private equity funds, real estate funds, many CDOs, CLOs and other structured products, some larger family partnerships, and potentially many others.[4]

Currently, Private Funds generally rely on the exceptions from the definition of "investment company" pursuant to sections 3(c)(1) or 3(c)(7) of the Investment Company Act. Private Funds entitled to rely on those exceptions do not require any significant regulatory compliance procedures under the Investment Company Act. Under the proposed Bill, the exceptions offered by sections 3(c)(1) and 3(c)(7) of the Investment Company Act would become exemptions; the text of sections 3(c)(1) and 3(c)(7) of the Investment Company Act would be moved to section 6(a) of the Investment Company Act and renumbered as sections 6(a)(6) and 6(a)(7) respectively.[5] The terms of sections 3(c)(1) and 3(c)(7) would not change substantively.[6] Under proposed section 6(a), small Private Funds would be exempt from proposed Investment Company Act registration requirements; larger Private Funds would be required to register and be subject to further compliance requirements as discussed in greater detail below.

Registration of certain ''large'' Private Funds under the Investment Company Act

Although the Bill provides that Private Funds would generally be exempt from the registration requirements of the Investment Company Act, a Private Fund with "assets, or assets under management," of $50 million or more (a "Large Private Fund") could only avail itself of the exemptions under new sections 6(a)(6) and 6(a)(7) if it:

- registers with the SEC;
- maintains books and records as required by the SEC;
- cooperates with any request for information or examination by the SEC; and

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3 The language in current section 3(c)(1) of the Investment Company Act relating to anti-pyramiding provisions of section 12(d)(1) of the Investment Company Act appears to have been deleted from proposed section 6(a)(6). Given statements from the Bill's sponsors that the proposed changes are technical rather than substantive, this may have been an oversight or a case of unclear drafting.

4 The definition of "investment company" is highly technical and may capture many entities that are not typically viewed as investment companies or investment funds.

5 Certain Private Funds may be able to rely on exceptions provided under other provisions of the Investment Company Act. For example, section 3(c)(5) of, or Rule 3a-7 under, the Investment Company Act may be available to certain structured product vehicles or certain real estate funds.

6 For example, registered investment advisers to Private Funds relying on new section 6(a)(7) would continue to be able to rely on the exemption relating to performance fees. However, it should be noted that there is one significant substantive change with respect to section 6(a)(7) exempted investment companies. Under the Bill, such an exempted investment company would be required to look through any exempted Private Fund investors (e.g., a fund of funds) that held 10% or more of the voting securities of the exempted investment company to determine if all of its investors were qualified purchasers. Currently, this look through requirement only applies to Private Funds relying on section 3(c)(1) of the Investment Company Act.

- discloses to the SEC the following:
  - the name and current address of each natural person with a beneficial ownership interest in the Private Fund;
  - the name and current address of each company with an ownership interest in the Private Fund;
  - the primary accountant and primary broker used by the Private Fund;
  - an explanation of the Private Fund's ownership structure;
  - information on the Private Fund's affiliation with another financial institution;[7]
  - the minimum investment commitment required from an investor;
  - the total number of investors in the Private Fund; and
  - the current value of the assets, and assets under management, of the Private Fund.

The Bill would require the foregoing information to be disclosed electronically to the SEC, at least annually, and would be available to the public in electronic searchable format. Within 180 days of passage of the Bill, the SEC would be required to issue forms and other guidance implementing the Bill.

Notwithstanding the current language of the Bill, the Bill's sponsors have clarified that the Bill does not require disclosure of the identities of investors in Private Funds, but rather disclosure regarding the managers of Private Funds that collect fees to operate such funds.[8] It now appears that this requirement of the Bill may be amended.[9]

Impact of registration requirement

Advisers to Large Private Funds would be required to register with the SEC as investment advisers

Currently section 203(b)(3) of the Investment Advisers Act of 1940, as amended (the "Advisers Act") generally exempts an adviser from the requirement to register provided that such adviser advises fewer than 15 clients, does not publicly hold itself out as providing investment advice, and does not advise any investment company registered under the Investment Company Act. This exemption would no longer be available to advisers to Large Private Funds registered with the SEC.[10] Similarly, an adviser primarily engaged in futures trading may no longer be able to rely on an exemption from registration with the SEC as an investment adviser. The Advisers Act currently exempts an adviser from the requirement to register with the SEC if such adviser is registered with the U.S. Commodity Futures Trading Commission ("CFTC") as a commodity trading adviser, provides advice primarily on investing in futures, and does not advise investment companies registered under the Investment Company Act.[11]

Registration obligations may affect Private Fund operations

The registration of Large Private Funds under the Investment Company Act presents the possibility of SEC oversight and examination. Private Funds should also consider whether any of the following may be triggered by the Bill's registration obligation:

- whether registration of a Private Fund may trigger notice requirements or default provisions under existing agreements (such as CDO and other

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7 The term "financial institution" is not defined in the Bill, although it is defined in the Bank Secrecy Act, *31 U.S.C. §5318*.

8 *See* joint statement issued by Senators Charles Grassley of Iowa and Carl Levin of Michigan on February 5, 2009, a copy of which is available at http://levin.senate.gov/newsroom/release.cfm?id=307821.

9 Investment companies that register under the Investment Company Act are not typically required to disclose the identity of their investors except in certain instances. Registration statements (e.g., Forms N-1A and N-2) for traditional investment companies do not require the identification of each investor, although such registration statements do require certain disclosures regarding an investment company's "control persons" and "principal holders."

10 Currently, it is not clear how the Bill would affect a non-U.S. adviser required to register with the SEC as the result of advising registered Large Private Funds. Under *Uniao de Banco de Brasileiros S.A.*, SEC Staff No-Action Letter (pub. avail. July 28, 1992) and other no-action letters, a registered non-U.S. adviser that advises only non-U.S. clients is generally not subject to the full regulatory regime of the Advisers Act; such an adviser however would be subject to the full requirements of the Advisers Act with respect to any U.S. clients.

11 *See* section 203(b)(6) of the Advisers Act.

structured product indentures in which transaction vehicles rely on sections 3(c)(1) or 3(c)(7), side letters, and service provider agreements, including prime brokerage documents);

- whether registration of the Private Fund's investment adviser and registration of the Private Fund may result in notice requirements to investors and possibly the opportunity to redeem from such Private Fund; and

- whether registration of the Private Fund may result in competing regulatory requirements in the case of Private Funds formed or "listed or formed" in offshore jurisdictions or subject to approval by non-U.S. regulators.

Uncertainty regarding application to non-U.S. funds

The Bill would require Large Private Funds to register with the SEC, regardless of whether the adviser were a U.S. or non-U.S. adviser. It is unclear whether, or how, the SEC staff's prior position regarding the application of the Investment Company Act to "foreign investment companies"[12] would be affected by the Bill. The Touche, Remnant & Co. no-action letter ("Touche Remnant")[13] generally recognized that for purposes of applying certain requirements under the Investment Company Act, a foreign investment company need only look to its U.S. offering and its investors who are "U.S. persons."[14] If the principles of Touche Remnant and subsequent related no-action letters continue to apply, it may be possible for a foreign investment company to include toward the $50 million threshold only those investments made by U.S. investors for purposes of determining whether such foreign investment company qualifies as a Large Private Fund; similarly, a foreign investment company may only be required to report information relating to its U.S. investors (e.g., the total number of investors). Alternatively, it is possible that a foreign investment company deemed to be a Large Private Fund registered under the Investment Company Act would be required to disclose information relating to all investors because it would not meet the existing test for a "foreign investment company."[15]

Uncertainty regarding disclosure and filing obligations

In addition to the above considerations, the current language of the Bill does not address the following issues which may be significant to potential Large Private Funds:

- whether or not feeder funds and master funds may be aggregated for purposes of the registration requirement;

- whether the test for "assets or assets under management" is a net or gross test and the relevant time at which the $50 million threshold is applied; and

- the method for valuing "assets or assets under management" of the Private Fund.

Uncertain tax treatment

The Bill does not address the tax treatment of Private Funds that would be required to register under the Investment Company Act. As currently drafted, the Bill may indirectly result in a change in the tax treatment of certain Private Funds that are now relying on the so-called "qualifying income exception" to avoid taxation as a corporation under the publicly traded partnership rules in section 7704 of the Internal Revenue Code (the "Code").[16] The qualifying income exception currently is

12 A "foreign investment company" is generally an investment company organized under laws other than the U.S. that is not registered under the Investment Company Act. *Touche, Remnant & Co.*, SEC Staff No-Action Letter (pub. avail. August 27, 1984). *See* also *Wilmer, Cutler & Pickering* and *Davis Polk & Wardell*, SEC Staff No-Action Letter (pub. avail. October 5, 1998).

13 *Id. See* also *Goodwin, Procter & Hoar*, SEC Staff No-Action Letter (pub. avail. Feb 28, 1997).

14 Touche Remnant recognized that the U.S. jurisdictional interest in a foreign investment company is based on a non-U.S. investment fund's specific actions in the U.S. or the effect in the U.S. of its activities conducted abroad and stated that only those beneficial owners that are resident in the U.S., rather than the total number of investors, would be considered for the purpose of calculating the applicable threshold with respect to the Investment Company Act. For example, non-U.S. Private Funds relying on section 3(c)(1) generally need only count U.S. investors for purposes of the 100 beneficial owner test, and non-U.S. Private Funds relying on section 3(c)(7) generally need only determine qualified purchaser status for U.S. investors.

15 Under sections 7(d) and 8 of the Investment Company Act, non-U.S. investment companies may register as investment companies provided they receive an order from the SEC. In practice, this has only rarely happened.

16 Under current law, absent an available exception, Private Funds that do not have sufficient restrictions on transfers and/or redemptions of interests in such Private Funds may be treated as publicly traded partnerships ("PTPs") that are generally taxed as corporations under Code sec-

not available to Funds that are registered under the Investment Company Act.[17] Either the Bill or the Code should be modified to allow Private Funds that are required to register under the Bill to retain tax treatment as a partnership under the qualifying income exception.[18]

Anti-money laundering requirements

The Bill also requires each investment company relying on the exemptions under new sections 6(a)(6) and 6(a)(7) to establish an anti-money laundering program and report suspicious transactions to the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN). These requirements apply to all such exempted investment companies, regardless of whether they are Large Private Funds. The Treasury Secretary, in consultation with the SEC and CFTC, is required to propose implementing rules within 90 days after the Bill becomes law, and to enact final rules within 180 days after the Bill becomes law.

Under the Bill, the new rules to be adopted by the Department of the Treasury would also require exempted investment companies to adopt risk-based due diligence policies, procedures, and controls reasonably designed to ascertain the identity of, and evaluate, any "foreign" persons that supply or plan to supply funds to the exempted investment company (including if appropriate "look-through" to beneficial owners).

The Bill also would subject exempted investment companies to the "120 Hour Rule," a statute enacted as part of the USA Patriot Act that requires banks and broker-dealers (but not registered investment companies) to respond to requests for information from an "appropriate federal banking agency" within 120 hours of receiving such a request.[19] An appropriate federal banking agency may require a financial institution to provide information and account documentation for any account opened, maintained, administered or managed in the United States by the financial institution. It is currently unclear which banking regulatory agency would have authority to submit such requests to exempted investment companies.

Ultimate fate of the Bill

The Bill has been submitted for consideration to the Senate Committee on Banking, Housing, and Urban Affairs, and significant changes may be included. As a result, it is difficult at this time to predict whether or when the Bill will be debated or passed, or even the content of any final legislation. Likewise, we cannot predict the nature or scope of regulatory guidance that may be issued in connection with final legislation.

Next *DechertOnPoint*: Hedge Fund Adviser Registration Act of 2009

In addition to the Bill, separate legislation was introduced on January 27, 2009 by Representatives Michael Capuano of Massachusetts and Michael Castle of Delaware entitled the "Hedge Fund Adviser Registration Act of 2009" (the "House Bill"). The House Bill would eliminate the exemption contained in section 203(b)(3) of the Advisers Act that exempts an investment adviser from the requirement to register with the SEC provided that (i) such adviser has advised fewer than 15 clients in the course of the preceding 12 months, (ii) does not hold itself out generally to the public as an investment adviser, and (iii) does not advise any investment company registered under the Investment Company Act.

The elimination of this exemption would effectively require all investment advisers to register with the SEC, without regard to the number of clients or types of clients advised by such investment advisers, unless a different exemption were available (except small advisers allocated to the States for registration). The House Bill has the potential to affect a greater number of advisers than the SEC's prior rule on

tion 7704. One exception frequently relied upon by a Private Fund to avoid taxation as a corporation under the PTP rules is the "qualifying income exception." This exception applies if at least 90% of a Private Fund's annual gross income is derived from certain qualifying sources. Code section 7704(c)(1).

17 *See* Code section 7704(c)(3).

18 If a U.S. Private Fund registers under the Investment Company Act, it could elect to be taxed as a regulated investment company ("RIC") if it is able to also satisfy requirements for RIC status, including certain requirements relating to the source of income and gains and diversification of assets. Code section 851. RICs must also satisfy certain minimum distribution requirements. Code section 852.

19 *See* 31 U.S.C. §5318(k)(2).

hedge fund adviser registration.[20] *Regardless of their size or client base, advisers (whether to a handful of clients, small family offices or investment funds with numerous investors) would be subject to SEC registration, inspection, and examination. A separate DechertOnPoint will be issued discussing the impact of the House Bill in greater detail.*

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[20] Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. §§275, 279). This rule has been nullified by a subsequent case, *Goldstein v SEC, 451 F.3d 873 (D.C. Cir. 2006). See* also *footnote 2*.

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