



## **HEDGE FUND REGISTRATION BILL ANNOUNCED**

*Senators Grassley and Levin Introduce Bill Requiring Hedge Fund Registration*

On January 28, 2009, Senator Charles Grassley, an Iowa Republican, and Senator Carl Levin, a Michigan Democrat, introduced a new bill on the floor of the Senate that, if passed, would impose a significant and sweeping new regulatory regime on the private investment fund industry.

The bill, called the Hedge Fund Transparency Act (the "Grassley-Levin Bill"), would require hedge funds with more than \$50 million in assets under management to register with the Securities and Exchange Commission. Such hedge funds would not be subject to all of the rules and regulations applicable to publicly offered registered investment companies (mutual funds), but they will be required to file an annual disclosure form with specific and detailed information about the fund that will be made publicly available, to maintain books and records required by the SEC, and to cooperate with any SEC information request or examination.

The Grassley-Levin Bill would dramatically change the application of the Investment Company Act of 1940, as amended (the "ICA") to currently unregistered private investment funds relying on the exclusions from the definition of an investment company provided in Sections 3(c)(1) and 3(c)(7) -- including funds whose investment managers are registered as investment advisers with the SEC under the Investment Advisers Act of 1940, as amended (the "Advisers Act") -- by making it clear that all such funds are "investment companies" within the meaning of the ICA; and, accordingly, are subject to the ICA's requirements and SEC oversight absent an exemption.

A copy of the full text of the Grassley-Levin Bill can be found at the following link: <http://grassley.senate.gov/private/upload/01292009-2.pdf>. A more detailed discussion of the various elements of the proposed legislation is set forth below.

### **Changing current 3(c)(1) and 3(c)(7) "Exclusions" into "Exemptions"**

Currently most hedge funds avoid the regulatory requirements of the ICA by relying on the statutory exclusions from the definition of "investment company" contained in Sections 3(c)(1) and 3(c)(7) of the ICA.

The Grassley-Levin Bill would delete Sections 3(c)(1) and 3(c)(7) and reinsert the language of those sections as new sections 6(a)(6) and 6(a)(7) of the ICA. Although new sections 6(a)(6) and 6(a)(7) preserve both paragraphs and makes no substantive changes to them, it moves them from Section 3 -- the part of the ICA that defines "investment company" -- to Section 6 -- the part of the ICA that exempts certain investment companies from the ICA's full set of requirements.

### **Requirements for Exemptions**

An investment company that satisfies either §6(a)(6) or §6(a)(7) and has *less than* \$50,000,000 in assets will be exempted from the provisions of the ICA. Thus, at first glance, it appears that

current 3(c)(7) and 3(c)(1) funds with less than \$50,000,000 will be unaffected by the Grassley-Levin Bill. However a hedge fund with assets or assets under management of \$50,000,000 or more, **can only avail themselves of the new exemptions if they:**

1. Register with the SEC;
2. Maintain such books and records as the SEC may require;
3. Cooperate with any request for information or examination by the SEC and
4. File, at least annually, an information form with the SEC electronically, that must be made freely available to the public in an electronic, searchable format and must contain, *at a minimum*, the following information:
  - (a) The name and current address of each individual who is a beneficial owner of the investment company.
  - (b) The name and current address of any company with an ownership interest in the investment company.
  - (c) An explanation of the structure of ownership interests in the investment company.
  - (d) Information on any affiliation with another financial institution.
  - (e) The name and current address of the investment company'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 investors.
  - (h) The current value of the assets of the company and the assets under management by the company.

The Grassley-Levin Bill also authorizes the SEC to require additional information it deems appropriate, essentially giving the SEC the authority to require hedge funds with assets of \$50,000,000 or more to open up their entire business and all books and records to the SEC. Theoretically, this could also include making other information available to the SEC and to the public.

### **Anti-Money Laundering Obligations**

The Grassley-Levin Bill also adds an anti-money laundering disclosure element for all funds relying on §6(a)(6) or §6(a)(7). This provision, the addition of which Sen. Levin is credited, makes it clear that hedge funds have the same obligations under the money laundering statutes as other financial institutions.

Specifically, the Grassley-Levin Bill requires that an investment company exempt under §6(a)(6) or §6(a)(7) must establish within one year of the enactment of the Grassley-Levin Bill an anti-money laundering program and report suspicious transactions under 31 U.S.C.A. 5318(g) and (h). In addition, the Grassley-Levin Bill directs Treasury to issue a final rule requiring hedge funds to establish anti-money laundering programs and, in particular, to guard against allowing suspect offshore funds into the U.S. financial system. Specifically, if the Grassley-Levin Bill

passes, the Treasury Secretary must establish a rule within 180 days of the enactment of the Grassley-Levin Bill setting forth minimum requirements for the anti-money laundering programs. The rule must require exempted investment companies to "use risk-based due diligence policies, procedures, and controls that are reasonably designed to ascertain the identity of and evaluate any foreign person that supplies funds or plans to supply funds to be invested with the advice or assistance of such investment company." The rule must also require exempted investment companies to comply with the same requirements as other financial institutions for producing records requested by a federal regulator under 31 U.S.C. 5318(k)(2). The rule also may incorporate elements of the Bush administration's 2002 proposed anti-money laundering rule for investment funds that was not finalized or adopted.

### **Impact on Registration Requirements under the Advisers Act**

In his opening remarks, Senator Grassley noted that the Grassley-Levin Bill is a revised version of S. 1402, which he introduced in the 110th Congress in response to the SEC's decision in Goldstein. The previous bill sought to amend the Advisers Act by requiring that investment managers relying on the "less than fifteen clients" exemption from registration under the Advisers Act contained in Section 203(b)(3) of the Advisers Act are required to "look through" the private funds that they manage and count the underlying beneficial owners as clients for purposes of counting under 203(b)(3). The Grassley-Levin Bill (as discussed above) seeks to amend the ICA, but does not (on its face) seek to amend the provisions of the Advisers Act. Grassley also noted this distinction in his opening remarks, but stated that "**the purpose is the same:** to make it clear that the Securities and Exchange Commission has the authority to require hedge fund registration."

Moreover, although the Grassley-Levin Bill does not technically amend the language of the Advisers Act, if passed, we are of the view that it will significantly alter the ability of unregistered managers to remain unregistered. If the proposed changes to the ICA were to go into effect, the result would be that any investment adviser managing a fund with \$50,000,000 or more in assets would, in addition to having to register the fund with the SEC as an investment company under the ICA, would also have to register itself with the SEC as an investment adviser under the Advisers Act. This is because Section 203(b)(3) exemption is unavailable to investment managers that advise investment companies registered with the SEC.<sup>1</sup> Thus, we are of the view that new Section 6(g) of the ICA will effectively render Advisers Act exemption 203(b)(3) unavailable for a vast amount of investment advisers that currently rely on that exemption to avoid registration under the Advisers Act. We will seek to confirm our understanding of the effect of the Grassley-Levin Bill.

**Timeframe and Rulemaking Authority:** The Grassley-Levin Bill has been referred to the

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<sup>1</sup> **Section 203b. Investment advisers who need not be registered.**

The provisions of subsection (a) shall not apply to--

- (3) any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser *nor acts as an investment adviser to any investment company registered under title I of this Act*, or a company which has elected to be a business development company pursuant to section 54 of title I of this Act and has not withdrawn its election. For purposes of determining the number of clients of an investment adviser under this paragraph, no shareholder, partner, or beneficial owner of a business development company, as defined in this title, shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner;

Senate Committee on Banking, Housing and Urban Affairs. If the Grassley-Levin Bill is passed, the SEC must issue forms and guidance to carry out this Act within 180 days after its enactment. Presumably, this would also shed some light on the registration forms (and related information) that would be required as part of the ICA registration process for hedge funds. The Grassley-Levin Bill (if passed) also authorizes the SEC to make a rule to carry out the Act.

At the moment there is no companion bill in the House of Representatives, however we would expect one would be proposed soon. In addition to Congressional support, it also has the support of the new administration and the regulators. The proposal was filed on Thursday amid the Obama administration efforts to prepare for a broader legislative overhaul of the regulatory system, which is also expected to include measures to more tightly regulate hedge funds. President Barack Obama's Treasury Secretary Timothy Geithner said he supported having a registration requirement because greater information and better disclosure were needed in the market place. The SEC's new chairman, Mary Schapiro, also has said she was supportive of requiring hedge funds to register with the SEC. Based upon the developments in this area that we have been closely monitoring over the past few months, we think it is highly likely that the bill will be enacted in some form or another.

## **Conclusion**

The Grassley-Levin Bill is far more reaching in scope and substance than Grassley's prior bills because if passed hedge funds will be subject not only to the provisions of the Advisers Act, but also to certain provisions of the ICA. The Grassley-Levin Bill makes it clear that hedge funds are subject to full SEC oversight. Although the Grassley-Levin Bill imposes a much, more limited set of obligations on hedge funds than other investment companies registered with the SEC, those obligations will nonetheless be a significant additional regulatory burden on hedge funds. In particular, we believe that we still need to get guidance on the scope and mechanics of the ICA registration process of hedge funds if this bill is passed into law. One possibility is that the SEC will require hedge funds to follow a similar process as applicable to mutual funds related to registration under the ICA. In addition, regardless of how limited the obligations might be viewed under the Grassley-Levin Bill, it should be noted that this proposed legislation (in Senator Levin's words) "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."

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