# HEDGE FUND LEGISLATION INTRODUCED IN HOUSE OF REPRESENTATIVES

*Representatives Castle and Capuano Introduce Package of Legislation Aimed at Regulating Hedge Fund Industry*

Just a few days after Senators Grassley and Levin introduced the Hedge Fund Transparency Act, Representatives Michael Castle (R-DE) and Michael Capuano (D-MA), introduced a package of legislation also aimed at regulating the hedge fund industry.

The House legislation, which was introduced on February 2, 2009, consists of three bills: (1) The Hedge Fund Adviser Registration Act of 2009; (2) The Pension Security Act of 2009; and (3) The Hedge Fund Study Act. The first of these bills, the Hedge Fund Adviser Registration Act of 2009, has the most significant impact on hedge fund managers. We are of the view that if passed, this bill will result in most (if not all) unregistered hedge fund managers being required to register as investment advisers with the Securities and Exchange Commission (the "SEC").

Further details on all three bills are provided below.

## Hedge Fund Adviser Registration Act of 2009[1]

The Hedge Fund Adviser Registration Act of 2009 contains only one sentence, striking in its entirety Section 203(b)(3) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"); however, if passed, the impact of this bill would be as significant as its text is brief.

Under current Section 203(b)(3), an investment adviser is not required to register with the SEC if it:

(1) has had fewer than 15 clients during the preceding 12 months;

(2) does not hold itself out to the public as an investment adviser; and

(3) does not advise any registered investment companies, such as mutual funds, or companies electing to be regulated as business development companies.

Section 203(b)(3), which is more commonly known as the "private adviser exemption," is the exemption upon which most (if not all) unregistered hedge funds managers currently rely to avoid registration with the SEC.[2] If Section 203(b)(3) is stricken from the

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[1] See http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h711ih.txt.pdf for a copy of the full text of the Hedge Fund Adviser Registration Act of 2009.

[2] We note that hedge fund managers currently exempt from registration under Section 203(b)(3) of the Advisers Act are nonetheless subject to a number of the Advisers Act provisions, including the antifraud provisions. However, registered investment advisers become subject to all provisions of the Advisers Act,

Advisers Act, all hedge fund advisers would be required to register unless they qualified for another exemption from registration (which is unlikely).

The Hedge Fund Adviser Registration Act of 2009 amends the Advisers Act, but unlike its counterpart in the Senate, the Hedge Fund Transparency Act (the "Grassley-Levin Bill"), the House bill does not include any amendments to the Investment Company Act of 1940, as amended (the "ICA"). The Grassley-Levin Bill would require hedge funds with more than $50 million in assets under management to register as investment companies with the SEC under the ICA.[3] As set forth in sub-paragraph (3) above, the Section 203(b)(3) exemption is unavailable to investment managers that advise investment companies registered with the SEC under the ICA. Thus, as we discussed in the Client Alert Memorandum on the Grassley-Levin Bill that we circulated last week, even though the Grassley-Levin Bill does not technically amend the language of the Advisers Act, if passed, we are of the view that it would effectively render Advisers Act exemption 203(b)(3) unavailable for investment advisers that manage funds with more than $50 million in assets. The House bill takes a more direct approach – it simply deletes Section 203(b)(3) altogether – thus making it unavailable for *all* investment advisers that currently rely on that exemption to avoid registration under the Advisers Act (regardless of the size or the number of funds they manage).

**Pension Security Act of 2009**

The second bill introduced by Representatives Castle and Capuano, the Pension Security Act of 2009[4], would amend Title I of the Employee Retirement Income Security Act of 1974, as amended to require disclosure of plan investments in hedge funds.[5] If passed, defined benefit pension plans would be required to make disclosures in their annual reports for plan years beginning on or after the date of the enactment. The disclosure would need to include a schedule identifying each hedge fund in which the plan invests as of the end of the plan year covered by the annual report and the amount so invested in each hedge fund.

The bill also directs the Secretary of Labor, in consultation with the SEC, to issue regulations to carry out the amendments not later than 1 year after the date of the enactment of the Pension Security Act of 2009.

**Hedge Fund Study Act[6]**

including requirements regarding annual disclosure, compliance policies and procedures, code of ethics, proxy voting rules and recordkeeping.

[3] See http://www.hedgeop.com/press%20releases/HFTA_memo.pdf for a copy of the full text of HedgeOp's Client Alert Memorandum on the Hedge Fund Transparency Act.

[4] See http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h712ih.txt.pdf for a copy of the full text of the Pension Security Act of 2009.

[5] For purposes of the amendment, the term "hedge fund" means an investment pool that (i) is excluded as an investment company under sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, and (ii) offers its securities pursuant to an exemption for private offerings provided by Section 4(2) of the Securities Act of 1933 and Rule 506 of Regulation D promulgated thereunder.

[6] See http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h713ih.txt.pdf for a copy of the full text of the Hedge Fund Study Act.

The third bill introduced by Representatives Castle and Capuano, the Hedge Fund Study Act, would require the President's Working Group on Financial Markets to conduct a study on the hedge fund industry.[7] Specifically, the study would include an analysis of:

- the changing nature of hedge funds and what characteristics define a hedge fund;
- the growth of hedge funds within financial markets;
- the growth of pension funds investing in hedge funds;
- whether hedge fund investors are able to protect themselves adequately from the risk associated with their investments;
- whether hedge fund leverage is effectively constrained;
- the potential risks hedge funds pose to financial markets or to investors;
- various international approaches to the regulation of hedge funds; and
- the benefits of the hedge fund industry to the economy and the markets.

The study must be completed no later than 180 days after the date of enactment of the Hedge Fund Study Act, when the President's Working Group on Financial Markets must submit a report on its findings to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate. The report must include the following recommendations:

- any proposed legislation relating to appropriate disclosure requirements for hedge funds;
- the type of information hedge funds should disclose to regulators and to the public;
- any efforts the hedge fund industry or regulators of financial institutions should undertake to improve practices or provide examples of successful industry initiatives; and
- any oversight responsibilities that members of the President's Working Group should have over the hedge fund industry, and the degree and scope of such oversight.

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[7] We note that both the Asset Managers Committee and the Investors Committee of the President's Working Group on Financial Markets each just completed a report on best practices for hedge funds. Drafts of the reports were released for comment from industry participants and other interested constituencies on April 15, 2008. The final best practices reports of the Asset Managers' and Investors' Committees were released on Jan. 16, 2009.