BILL INTRODUCED IN SENATE TO SUBJECT PRIVATE FUNDS AND THEIR ADVISERS TO SEC REGISTRATION

Yesterday, Senators Chuck Grassley (R-Iowa) and Carl Levin (D-Michigan) introduced a bill in the United States Senate that would require most hedge funds and other unregistered private funds with assets of at least $50 million to register with the Securities and Exchange Commission under the Investment Company Act of 1940 and to comply with certain other rules. Specifically, the Hedge Fund Transparency Act (the "Bill") would exempt a fund with assets of at least $50 million from most of the 1940 Act's provisions only if the fund registers with the SEC, files a publicly available report disclosing specified information (including most notably the identity of its owners), maintains books and records to be specified by the SEC, and cooperates with any request for information or examination by the SEC. **Notably, the Bill would also have the effect of requiring the investment advisers to these funds to register with the SEC under the Investment Advisers Act of 1940.** It is unclear what other collateral consequences would result if the Bill were enacted into law.[1]

Most hedge funds and other private funds are currently excluded from the definition of "investment company," and therefore are not subject to the 1940 Act, by virtue of Section 3(c)(1) or Section 3(c)(7) of the 1940 Act.[2] If adopted, the Bill would eliminate the Section 3(c)(1) and Section 3(c)(7) exclusions and instead would exempt from the provisions of the 1940 Act a fund that meets substantially the same criteria currently set out in Section 3(c)(1) or Section 3(c)(7) (hereafter, a "Private Fund") as long as the Private Fund has less than $50 million of assets. A Private Fund with assets of $50 million or more would be exempt from most of the 1940 Act's provisions only if it complied with the obligations imposed by the Bill.[3] A Private Fund that was subject to but failed to satisfy these obligations would become subject to the much more extensive substantive provisions imposed under the 1940 Act on registered investment companies, including limitations on leverage, periodic reporting requirements, board composition requirements, rules pertaining to the custody of fund assets and restrictions on transactions with affiliates. Most hedge funds and private equity funds would have extreme difficulty complying with these regulations.

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[1] For example, certain family companies, special purpose entities used in securitizations and other business entities currently exempt under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act could become subject to these requirements.

[2] Respectively, these sections exclude from the definition of "investment company" hedge funds and other private funds with not more than 100 beneficial owners or whose investors are limited to qualified purchasers and knowledgeable employees, and that do make or propose to make a public offering of their securities.

[3] As is the case under current law, under the proposed Bill Private Funds would still be subject to the anti-pyramiding provisions of Section 12(d)(1) of the 1940 Act that limit the percentage ownership by a Private Fund of a registered investment company.

If adopted, the Bill would also require Private Funds, regardless of size, to establish an anti-money laundering program and to report suspicious transactions under Section 5318 of Title 31 of the United States Code. To comply, many Private Funds might need to outsource these obligations because of a lack of internal resources, adding significantly to the cost of compliance.

Reporting and Other Requirements Imposed by the Bill

Under the Bill, a Private Fund with assets of $50 million or more would be exempt from the provisions of the 1940 Act only if the Private Fund:

(A) registers with the SEC;

(B) files an "information form" with the SEC;

(C) maintains such books and records as the SEC may require; and

(D) cooperates with any request for information or examination by the SEC.[4]

As to the registration requirement, the Bill does not specify how such registration would be effected, but it may be that a Private Fund would be required to file with the SEC the current Notice of Registration on Form N-8A or a similar form. Form N-8A currently requires disclosure of basic information about a registrant, including identifying information about its investment manager, its officers, directors and sponsors (as applicable), the nature of its securities offering (public or private) and other basic information. It is unclear whether more substantive information would be required of Private Funds pursuant to the registration requirement, such as the information currently required to be provided by a registered open-ended investment company in a Form N-1A Registration Statement. As to the "information form" required by the Bill, the form must be electronically filed at such time and in such manner as the SEC requires but not less frequently than once every 12 months. The form would be made available to the public and would include:

(i) the name and current address of each natural person who is a beneficial owner of the fund, any company with an ownership interest in the fund, and the fund's primary accountant and primary broker;

(ii) an explanation of the structure of ownership interests of the fund;

(iii) information on any affiliation that the fund has with another financial institution;

(iv) a statement of any minimum investment commitment required of the fund's investors;

[4] If enacted, the Bill would require the SEC to issue such forms and guidance as is necessary to implement these provisions within 180 days of the Bill's enactment.

(v) the total number of investors in the fund; and

(vi) the current value of the fund's assets and any assets under the fund's management.

Of these, the obligation to disclose the names and addresses of beneficial owners may prove to be the most controversial.

Registration of Investment Adviser under the Advisers Act

As noted above, the Bill would have the effect of requiring every investment adviser to a Private Fund with assets of $50 million or more to register with the SEC under the Advisers Act. Currently, investment advisers to Private Funds often are exempt from SEC registration by reason of Section 203(b)(3) of the Advisers Act, which exempts advisers that advise fewer than fifteen clients and that do not hold themselves out to the public as an investment adviser. However, this exemption is in part predicated on the adviser not acting as an investment adviser to any investment company that is registered under 1940 Act. Since the Bill would require Private Funds with assets of $50 million or more to register under the 1940 Act, advisers to these Funds would no longer qualify for the 203(b)(3) exemption and, absent some other exemption, would be required to register under the Advisers Act in order to continue to manage their funds.

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We will continue to monitor the progress of the Bill and keep you informed as developments arise. If you have any questions concerning the foregoing or would like additional information, please contact Barry P. Barbash (202-303-1201, bbarbash@willkie.com), Daniel Schloendorn (212-728-8265, dschloendorn@willkie.com), Roger D. Blanc (212-728-8206, rblanc@willkie.com), Emily M. Zeigler (212-728-8284, ezeigler@willkie.com), Rita M. Molesworth (212-728-8727, rmolesworth@willkie.com), Margery K. Neale (212-728-8297, mneale@willkie.com), Adrienne L. Atkinson (212-728-8253, aatkinson@willkie.com), Maria Gattuso (212-728-8294, mgattuso@willkie.com), James G. Silk (202-303-1275, jsilk@willkie.com), Joseph P. Cunningham (212-728-8161, jcunningham@willkie.com), or the attorney with whom you regularly work.

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