

Client Alert

An informational newsletter from Goodwin Procter LLP

Proposal to Regulate Private Funds and Their Advisers Introduced in U.S. Senate

On January 29, 2009, Senators Carl M. Levin (D-MI) and Charles E. Grassley (R-IA) introduced a bill titled the “Hedge Fund Transparency Act” (the “Bill”).¹ Although its title references only “hedge funds,” the Bill would affect a wide array of private investment funds, including certain venture capital, private equity and similar funds (“Private Funds”). The Bill may also impose new regulations on Private Fund general partners, management companies and similar investment advisers.

This Alert briefly describes certain of the Bill’s key elements. It is important to note that the introduction of the Bill is only a preliminary step on a path that may, or may not, lead to increased regulation. It is likely the Bill will change over time, as it becomes integrated with other proposals of similar focus and as other stakeholders offer their views on how best to regulate the Private Fund industry in the future. For example, a different bill was introduced in the U.S. House of Representatives two days before the Bill’s introduction.² Press reports indicate that President Obama’s administration, state regulators and a Congressional panel are likewise preparing proposals of their own. While it is prudent to monitor such developments, no one can know today how, or if, the Private Fund regulatory landscape will ultimately change (although many commentators believe that some form of additional regulation is likely).

The Bill Applies to a Broad Range of Private Funds

As Senator Levin’s floor speech made clear, the Bill addresses not just “hedge funds,” but *any* entity with \$50 million or more in assets (or “assets under management”) relying on the exclusions from the definition of “investment company” currently found in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the “1940 Act”).³ The Bill proposes to delete these exclusions in Sections 3(c)(1) and 3(c)(7) and would add, in Section 6 of the 1940 Act, two new substantially similar exemptions. However, the Bill would require Private Funds relying on these new Section 6 exemptions to satisfy additional requirements, as summarized below in this Alert.⁴

Disclosure and Compliance Obligations

For a Private Fund with \$50 million or more in assets to qualify under the new Section 6 exemptions, it would be required to: (i) register with the SEC (although the Bill does not define “register”); (ii) file an annual information form with the SEC; (iii) maintain such books and records as may be required by the SEC; and (iv) cooperate with SEC requests for information and inspection. A Private Fund’s annual information form would include disclosure of: (a) the names and addresses of Fund investors (including all natural persons with “beneficial” ownership of the Fund); (b) the structure of the Fund’s ownership interests; (c) the Fund’s primary accountant and “primary” broker; (d) information regarding the Fund’s affiliations with “financial institutions”; (e) any minimum investment requirement applicable to Fund investors; (f) the total

number of Fund investors; and (g) the current value of the Fund's "assets" and "assets under management." Information provided on this form would be publicly available in an electronic, searchable format.

Among the Bill's provisions, these annual reporting requirements may see the most intensive debate. For example, public disclosure of investor names and addresses would raise significant privacy concerns and disclosing valuation information could be particularly problematic for venture capital and private equity funds, where valuations of portfolio companies are treated as proprietary information.

In addition, if Private Funds were required to "register" with the SEC under the 1940 Act, absent further clarification, their general partners, management companies and similar investment advisers would be required to register under the Investment Advisers Act of 1940 (the "Advisers Act"). Private Fund advisers typically rely on Advisers Act Section 203(b)(3), which, broadly stated, exempts an investment adviser with fewer than 15 clients from registering under the Advisers Act, so long as the adviser does not hold itself out to the public as an investment adviser and does not advise an investment company *registered* under the 1940 Act.⁵ If required to register under the Advisers Act, a Private Fund adviser would be obligated to file public disclosures, submit to SEC inspections, adopt a formal regulatory compliance program and satisfy additional requirements.

Anti-Money Laundering Obligations

The Bill would impose certain anti-money laundering obligations on Private Funds that rely on the new Section 6 exemptions, without regard to whether such Funds hold assets of \$50 million or more. The Bill would require Private Funds to: (i) establish anti-money laundering ("AML") programs; (ii) ascertain the identity of, and "evaluate," foreign investors; and (iii) monitor and report to the U.S. government regarding suspicious transactions. These obligations could impose material compliance burdens on Private Funds and their advisers and, except for the requirement regarding AML programs, go beyond what the U.S. Treasury Department previously proposed for hedge funds.

Monitoring Future Developments

The Bill is one initial proposal for regulating Private Funds and their advisers. It is impossible to predict when and if the Bill or any similar proposal would come into effect. However, given the scope and number of current proposals, and ongoing difficulties in the economy and public markets, some form of enhanced regulation appears likely. We will monitor the Bill and other material proposals as they progress.

¹ S. 344: <http://grassley.senate.gov/private/upload/01292009-2.pdf>

² H.R. 711: <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.711.IH>:

³ The Bill defines neither “assets,” nor “assets under management.” We also note that the Bill does not address other exemptions currently found in Section 3(c).

⁴ The Bill also arguably broadens the SEC’s ability to regulate Private Funds in the future by creating the new exemptions in Section 6, instead of simply modifying the exclusions in Section 3.

⁵ Note that H.R. 711, mentioned above, would delete Section 203(b)(3) in its entirety.

For further information about the issues raised in this alert, please contact any of the attorneys listed below.

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