



Legal Risk Management Tip

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Hedge Fund Legislation: Further Proposals

Introduction

Congress currently is considering three separate bills which concern “hedge funds.” The bills are as follows:

- The Hedge Fund Adviser Registration Act of 2009;
- The Hedge Fund Transparency Act; and
- The Hedge Fund Study Act.

Currently, none of these bills have passed the committee stage and still have a long way to go before any of them become law, if at all. However, given the legislative and public appetite to increase the regulation of hedge funds, it is possible that at least one of these bills, or a combination thereof may be promulgated in the near future. In fact, on May 14th Ms. Schapiro, Chairperson of the Securities and Exchange Commission, made the following comments in a recent interview with Business Week:

“I do think the SEC will be given authority to register and regulate hedge funds. There is a broad consensus that unregulated parts of our financial system—whether it's hedge funds, credit-default swaps, or other investment vehicles—have to come under the regulatory umbrella. That doesn't mean we stuff hedge funds into the investment company model but rather we regulate them with the understanding that there are unique aspects to their business. It's completely appropriate for that to happen, and I expect it will this year.”¹

Based on the foregoing, JLG believes that there could be an impact to all types of private funds and their advisers. Thus, we have provided a synopsis of these bills below, including highlights on the key proposals.

The Hedge Fund Adviser Registration Act of 2009

As the title implies, The Hedge Fund Adviser Registration Act of 2009 (“the Adviser Bill”) will require certain private investment fund advisers to register as investment advisers. Despite its title, this will include certain venture capital and private equity fund advisers as well as hedge fund advisers.

At present, Section 203(b) of the Investment Advisers Act of 1940 (“the IA Act”) provides an exemption from registration to those investment advisers who advise less than fifteen clients. If passed, the Adviser Bill will remove this exemption.² Many fund advisers have until now avoided registration with the SEC on the basis that each fund they advise is counted as one client only. By removing the exemption, such firms will need to register with the SEC.

¹ www.businessweek.com, May 14, 2009, SEC Chief Mary Schapiro: The Watchdog's New Teeth, May 27, 2009, (http://www.businessweek.com/magazine/content/09_21/b4132013769154.htm?campaign_id=rss_topStories).

² Hedge Fund Adviser Registration Act of 2009, H.R. 711, 111th Cong., 1st Sess. § 2 (2009).

In its current form, the Adviser Bill does not reference Rule 203a-1 under the IA Act, which provides that only investment advisers with assets under management of at least \$30,000,000 must register with the SEC. Therefore, even if the Advisers Bill becomes law, those firms who advise funds with combined assets of less than \$30,000,000 should be able to avoid registration with the SEC. Such firms should still consider and comply with their respective state de minimis requirements, which may require registration with appropriate state regulators.

Finally, it is likely that the Adviser Bill also will impact niche investment advisers who manage only a small number of high net worth accounts, such as family office advisers. To the extent these firms have been able to avoid registration on the basis of having less than fifteen clients, this will change if the Adviser Bill becomes law.

The Hedge Fund Transparency Act

If passed, the Hedge Fund Transparency Act (“the Fund Bill”) will require certain private investment funds to register with the SEC as investment companies under the Investment Company Act of 1940 (“the 1940 Act”).

At present, such funds fall outside of the definition of an investment company provided they comply with either Section 3(c)(1) or 3(c)(7) under the 1940 Act.

Under the current proposals these funds will be reclassified as investment companies³. However, only those funds that have assets under management of at least \$50,000,000 will be required to register with the SEC⁴. Even then, the fund will be able to secure an exemption from complying with the full investment company regulation but only if they agree to submit certain confidential information and potentially sensitive information to the SEC.

The Fund Bill provides that in order to obtain the exemption funds would be required to submit a public annual report to the SEC containing investor names and addresses⁵. Further, they will be required to “cooperate with any request for information or examination by the Commission”⁶. Although there is no indication as to what sort of information may be requested by the SEC under this provision, the use of the word “any” in this context has the potential to be overly broad, as it could mean that affected funds will be requested to disclose *any* information of *any* type.

Finally, the Fund Bill will require all hedge funds that become reclassified as investment companies (not just those with assets under management of at least \$50,000,000) to establish anti-money laundering programs and report suspicious transactions to the Financial Crimes Enforcement Network⁷.

The Hedge Fund Study Act

The Hedge Fund Study Act (“the Study Bill”) does not contain any proposed laws. Instead, the Study Bill will merely order the President’s Working Group on Financial Markets (“the Group”) to conduct a study on the hedge fund industry⁸. The purpose of this study will be to produce recommendations relating to:

³ Hedge Fund Transparency Act, S. 344, 111th Cong., 1st Sess. § 2(a) (2009).

⁴ Id. at § 2(g).

⁵ Id. at § 2(g)(2).

⁶ Id at § 2(g)(1)(D).

⁷ Id at § 4(b)

⁸ Hedge Fund Study Act, H.R. 713, 111th Cong., 1st Sess. § 2(a) (2009).

- New disclosure legislation;
- Steps hedges funds and regulators should take to improve practices; and
- Providing members of the Group with oversight responsibilities over the hedge fund industry and specifying the degree and scope of such oversight.⁹

Any recommendations would probably need to be set out in a future bill which also would need to be passed by Congress in order to become law. As such, there is arguably no real merit in speculating about what the Group may recommend if they do become empowered under the Study Bill. Nevertheless, it is interesting to note that the drafters of the Study Bill envisage the Group being responsible for the oversight of the hedge fund industry. Given that they will be permitted to recommend the “degree and scope” of their oversight, it is possible that they could recommend that such oversight include regulating the industry.

Conclusion

As stated previously, it is not clear which, if any of these bills will become law. Nevertheless, members of the private fund industries should be acutely aware of the possibility of being subjected to newly proposed legislation. Such rule promulgation could lead to significantly increased supervision and/or regulation by the SEC, which potentially may impact the internal operations of hedge fund firms. As such, funds should review and perhaps prepare for enhancements to their existing compliance controls, including policies and procedures, in order to stay ahead of the curve.

It should also be noted that there is additional proposed legislation on the horizon which could potentially impact private funds and advisers above and beyond the “hedge fund” bills discussed above. The SEC has recently proposed amendments to Rule 206(4)-2 under the IA Act which would lead to increased regulation of private fund managers and those registered investment advisers that have custody of client assets.¹⁰ At present, only part of these amendments might appear to apply to private fund managers as only registered investment advisers will be affected by all of the proposals. However, if the Adviser Bill becomes law and such advisers are required to register with the SEC, all of these amendments will become relevant to them.

JLG will continue to monitor and report on the proposed bills and any other potential new laws or rules that may be on the horizon.

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This article is for information purposes and does not contain or convey legal advice. The information herein should not be relied upon in regard to any particular facts or circumstances without first consulting with a lawyer.

⁹ Id. at § 2(b).

¹⁰ www.sec.gov, May 20, 2009, Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2876, May 27, 2009, (<http://www.sec.gov/rules/proposed/2009/ia-2876.pdf>).