HUNTON& WILLIAMS

PRIVATE INVESTMENT FUND UPDATE

February 2009

Private Investment Fund Legislation Introduced

On January 29, 2009, Senators Chuck Grassley (R-Iowa) and Carl Levin (D-Michigan) introduced the "Hedge Fund Transparency Act," which would result in significant changes in the oversight of private investment funds (such as hedge funds, private equity funds and venture capital funds). In their statements introducing the Grassley-Levin Bill, both Senators alluded to the need to provide the Securities and Exchange Commission with appropriate authority to oversee and regulate private funds in the wake of the 2006 decision by the D.C. Circuit Court of Appeals overturning the so-called "Hedge Fund Rule" requiring hedge fund advisers to register with the SEC as investment advisers.[1] A copy of the Bill is available here.

Overview

Currently, many private funds avoid regulation under the Investment Company Act of 1940 because they fall within one of the "exceptions" to the definition of "investment company" found in Section 3(c)(1) (for funds with fewer than 100 investors) or Section 3(c)(7) (for funds whose investors are exclusively comprised of "qualified purchasers") of that Act. The Grassley-Levin Bill would delete the Section 3(c)(1) and the Section 3(c)(7) exceptions and would include new "exemptions" in Section 6 of the Investment Company Act that would largely restate the Section 3(c)(1) and Section 3(c)(7) "exceptions."

However, the Grassley-Levin Bill would impose new obligations on most funds - those with assets or assets under management of $50 million or more. These "large investment companies" would receive the benefit of the new "exemptions" only if they:

- register with the SEC;
- file an information form with the SEC annually;
- maintain such books and records as the SEC may require; and
- cooperate with the SEC's information requests and examinations.

The information form required for "large investment companies" would have to be made available to the public in electronic format and to include the following information:

- the names and addresses of the fund's beneficial owners (both individuals and companies);
- the names and addresses of the fund's primary accountants and primary brokers;
- an explanation of the ownership interests in the fund;
- information on affiliations with other financial institutions;
- a statement of the minimum investment commitment required of investors;
- the total number of investors; and
- the current value of the fund's assets and any assets under management by the fund.

No indication is provided in the Bill as to whether the information required for the initial registration of a "large investment company" will be more or less burdensome than the annual information form. Also, the distinction between assets "of the investment company" and assets "under management" is unclear and will require further clarification by the SEC if the Bill is passed.

In addition, all funds relying on the new exemptions would be required to establish anti-money laundering programs under guidance to be established by the Secretary of the Treasury within 180 days of the enactment of the Grassley-Levin Bill. The Grassley-Levin Bill also proposes a number of conforming changes to references in the Investment Company Act, the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Advisers Act. If the Bill is enacted, the SEC would have 180 days to promulgate additional implementing rules and guidance regarding the Bill.

[1] Rule 203(b)(3)-2, which required certain private investment fund managers to register under the Investment Advisers Act of 1940, as amended, was vacated and remanded by the U.S. Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC*.

Implications

While the title of the Grassley-Levin Bill refers to "hedge funds," the proposed amendments to the Investment Company Act would not be limited to hedge funds. Many private equity funds, venture capital funds and other types of private investment funds also rely on the exceptions found in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act.

Although the replacement of the Sections 3(c)(1) and 3(c)(7) "exceptions" with new Section 6 "exemptions" may seem technical in nature, the effect would be to include 3(c)(1) and 3(c)(7) funds within the scope of the Investment Company Act as "investment companies" and, at least with respect to "large investment companies," subject them to additional registration, information and other requirements. In addition, the Grassley-Levin Bill does not clarify whether the "large investment company" registration requirements would result in such a fund being considered a "registered investment company" under the Investment Company Act. If so, such funds would be subject to additional provisions of the Investment Company Act, the Investment Advisers Act, and other securities laws.

The proposed amendments do not clearly address the implications for fund managers under the Investment Advisers Act. Many private investment fund managers have avoided registration under the Investment Advisers Act in reliance on the "fewer than 15 clients" exemption in Section 203(b)(3) of the Investment Advisers Act and the client counting rules found in Rule 203(b)(3)-1 under the Investment Advisers Act. Under this exemption, an investment adviser that had fewer than 15 clients during the preceding 12 months is exempt from registering as an investment adviser, provided it does not act as an investment adviser to a "registered investment company." Because the Grassley-Levin Bill does not address whether a "large investment company" is deemed a "registered investment company" by virtue of the new registration requirement, it is unclear whether the manager of such a "large investment company" may be required to register as an investment adviser.

The proposed new disclosure obligations will result in a significant expansion of the information available to the public regarding fund investments, valuations and investors, far beyond the information otherwise made available (for example, through state and governmental plan investors with public disclosure obligations or by Form D filings). Since most private funds consider such information to be highly confidential and of competitive nature, the proposed amendments could have an unsettling effect on these firms.

Conclusion

The Grassley-Levin Bill has been referred to the U.S. Senate Banking, Housing, and Urban Affairs Committee for review (although committee action is not necessarily required before the Bill could be acted upon or attached to other legislation). In light of other recent calls for regulation of systemically significant private funds, such as the recommendations released on January 15, 2009 by the "Group of Thirty" under the leadership of Paul Volker, and recent statements by Barney Frank (D-Massachusetts), Chairman of the House Financial Services Committee, and others in Congress, we anticipate that the Grassley-Levin Bill will receive significant attention, perhaps in conjunction with other similar proposed legislation.

Additional Information

The Hunton & Williams Private Investment Fund practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings and compliance. We will continue to monitor the progress of this legislation as well as other relevant trends in private investment fund regulation. If you have any questions, please contact us.

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