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CLIENT UPDATE

Proposed Law Would Require SEC Registration and Filings, and Anti-Money Laundering Procedures for Certain Private Investment Funds (and Possibly SEC Registration for their Advisers)

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On January 29, 2009, a bill was introduced in the US Senate (the "Transparency Act"),[1] which, if it were to become law, would require certain private investment funds, including hedge funds, private equity funds, private real estate funds, securitization vehicles, and family offices, among others, with $50 million or more in assets or assets under management, to register with the US Securities and Exchange Commission (the "SEC") as investment companies[2] (albeit subject to lighter regulation than typical investment companies), make significant public disclosures and establish anti-money laundering programs. Even issuers that fall below the $50 million threshold will be subject to some new requirements, as detailed below.

While the Transparency Act's full name implies that its scope is limited to hedge funds, in fact, it would affect *all* investment funds that rely on Section 3(c)(1) or 3(c)(7)[3] under the Investment Company Act of 1940 (the "Investment Company Act") to avoid being deemed investment companies.[4] These two provisions currently allow certain funds to be excluded from the definition of an "investment company" under the Investment Company Act. In particular, Section 3(c)(1) excludes any fund the outstanding securities of which are beneficially owned by not more than 100 beneficial owners, and that is not making or proposing to make a public offering of its securities. Section 3(c)(7) excludes any fund the outstanding securities of which are owned exclusively by "qualified purchasers" (generally, individuals owning not less than $5 million, and entities owning not less than $25 million, of certain investments), and that is not making or proposing to make a public offering of its securities.

In light of the current financial crisis, which has included accusations of market manipulative behavior, there is sentiment in Washington to bring much greater transparency to the market and activities of significant intermediaries. The senators who introduced the legislation believe that by requiring private investment funds to submit to some form of registration, there will be increased transparency in the markets. They also believe that the current lack of transparency has contributed to the

existing financial crisis. In order to ensure that most private investment funds cannot escape the reach of the Transparency Act, the sponsors drafted the legislation with a very broad reach, covering *all* vehicles, regardless of how they refer to themselves, which currently rely on Investment Company Act Section 3(c)(1) or 3(c)(7).[5]

The Transparency Act

The Transparency Act would transform Sections 3(c)(1) and 3(c)(7) into new Sections 6(a)(6) and 6(a)(7) of the Investment Company Act, respectively, and impose certain conditions on private funds that rely on these sections to exempt them from full registration as investment companies.[6] While appearing merely "technical," these changes will, in fact, have significant substantive effects, as discussed below. In essence, the changes convert private investment funds that rely on Section 3(c)(1) or 3(c)(7) from issuers that are not "investment companies,"[7] to issuers that are "investment companies" but that are exempt from most of the provisions of the Investment Company Act, so long as they comply with Section 6(a)(6) or 6(a)(7).

Funds relying on the new exemptions under Section 6(a)(6) or 6(a)(7) of the Investment Company Act with assets or assets under management of $50 million or more are referred to hereafter as "Private Funds" (regardless of whether they might not have considered themselves "funds"). Those with less than $50 million in assets or assets under management are referred to hereafter as "Small Private Funds." Private Funds (but not Small Private Funds) would be required to comply with the following requirements to remain exempt from the operational provisions of the Investment Company Act:

- Register with the SEC;
- Maintain certain books and records that the SEC may require;
- Cooperate with any request by the SEC for information or examination; and
- File an information form (described below), at least annually, with the SEC (which will be made publicly available).

In addition, both Private Funds *and* Small Private Funds would be required to establish anti-money laundering programs with a sufficient level of transaction monitoring to enable them to report suspicious transactions.

FILING REQUIREMENTS

At least annually,[8] Private Funds (but *not* Small Private Funds) will be required to file an information form with the SEC[9] to report:

- The name and address of each natural person who is a beneficial owner of the Private Fund;
- The name and address of any company with an ownership interest in the Private Fund;
- Information regarding the structure of ownership interests of the Private Fund;
- Disclosure of any "affiliates" that the Private Fund has that are other financial institutions;

- The name and address of the Private Fund's primary accountant and primary broker;
- Disclosure of any minimum investment commitment required of a limited partner, member, or investor investing in the Private Fund;
- The Private Fund's total number of current limited partners, members, or other investors; and
- The current value of the Private Fund's assets and the assets under management.

While the Transparency Act does not specifically reference the types of liability that may be imposed upon Private Funds as a result of these filings, one possibility is that existing antifraud provisions will apply to misstatements or omissions made to the SEC in these public filings.

The Transparency Act did not indicate whether there will be guidance forthcoming relating to how "beneficial ownership" will be defined for the purpose of these reporting requirements. In addition, Private Fund sponsors will have to deal with any issues arising out of pre-existing confidentiality covenants which cover the information the Private Fund would be required to report.

The requirement to disclose the names and addresses of all beneficial owners will no doubt be troubling for many Private Funds. In addition to obvious investor privacy concerns,[10] for those Private Funds the interests in which are traded among investors in an established secondary market (*e.g.*, certain securitization vehicles), it might become difficult to keep track of all current beneficial owners in order to meet the regulatory requirements imposed by the Transparency Act.

WHAT DOES IT MEAN TO BE "EXAMINED" BY THE SEC?

Under the Transparency Act, all Private Funds would need to cooperate with any request for information[11] or examination by the SEC.[12] Currently, registered funds and investment advisers are subject to examinations conducted by the SEC's Office of Compliance, Inspections and Examinations ("OCIE"). Examinations are generally performed on relatively short notice and typically involve the production of requested information, interviews and onsite inspections. They may last between two days and several weeks, depending on the size and nature of fund business and the findings of the examination.

There are usually three possible outcomes for an examination. First, the examiners may find only minor deficiencies, which are typically discussed in an exit interview followed by a form letter indicating that the examination process is complete. Second, if more serious deficiencies are found, they are reported to the registrant in a deficiency letter. The registrant must respond to OCIE by detailing the steps it will take to correct the deficiencies and can expect follow-up from the SEC staff on these points in the next examination. Third, if the examiners find violations of law, OCIE will refer the registrant to the SEC's Enforcement Division for legal action. OCIE may also perform "for cause" inspections without notice if it

believes there are ongoing violations of law or may perform "sweep" examinations of all registrants with particular business characteristics. Private investment funds that are managed by registered investment advisers are already subject to these examination requirements.

ANTI-MONEY LAUNDERING REQUIREMENTS

The Transparency Act would require Private Funds and Small Private Funds to establish anti-money laundering programs and to report suspicious transactions under the US Bank Secrecy Act. The Treasury Secretary, in consultation with the SEC and the US Commodity Futures Trading Commission, must propose a rule within 180 days of the enactment of the Transparency Act establishing the minimum policies, procedures and controls required for the anti-money laundering programs. Unlike the anti-money laundering requirements that currently apply to registered investment companies, the new rule must require the Private Fund or Small Private Fund to "use risk-based due diligence policies, procedures, and controls that are reasonably designed to ascertain the identity of and evaluate any *foreign* person… that supplies funds or plans to supply funds to be invested with the advice or assistance of such investment company."[13] The rule must also require Private Funds and Small Private Funds to comply with the same requirements as other financial institutions for producing records requested by a US federal bank regulator no later than 120 hours after receiving such request.[14] If a final rule is not issued by the Treasury Secretary, the anti-money laundering requirements, as set forth in the Transparency Act, would take effect one year after the date of enactment of the Transparency Act.

Other Issues

ADVISERS ACT REGISTRATION

At this time, it is unclear whether the Transparency Act would require investment advisers to any of the affected funds to be registered under either the Investment Advisers Act of 1940 (the "Advisers Act") or state law. Many advisers to unregistered funds rely on Advisers Act Section 203(b)(3), which exempts from SEC registration any adviser with fewer than 15 clients not holding itself out to the public as an investment adviser, and not providing advice to any investment company "registered" under the Investment Company Act.[15] Because the Transparency Act's language specifically references "registration" of Private Funds under the Investment Company Act, this may preclude reliance by their investment advisers on the Advisers Act exemption.[16]

FAILURE TO COMPLY WITH SECTIONS 6(A)(6) AND 6(A)(7)

Because the Transparency Act would eliminate the exclusion for private investment funds (*i.e.*, Sections 3(c)(1) and 3(c)(7)) from the definition of "investment company," failure to comply with the applicable filing requirements of Section 6(a)(6) or Section 6(a)(7) by a Private Fund or a Small Private Fund would presumably result in the same penalties that currently apply to any failure to register as an investment company. These can include, among other things, contracts being deemed void and possible

rescission of transactions, as well as civil money penalties. In addition, certain private funds' agreements (*e.g.*, limited partnership agreements of private equity funds) typically provide that a general partner of a fund can be removed for certain acts, including non-compliance with laws. A failure to comply with Section 6(a)(6) or 6(a)(7) that results in other violations of the Investment Company Act could, depending upon the circumstances, trigger a "for cause" removal of a general partner.

EFFECTS ON FUNDS RELYING ON POTENTIAL "ALTERNATIVE" EXCLUSIONS

In addition to relying on Section 3(c)(1) or 3(c)(7), some types of Private Funds may rely on other exclusions from status as an investment company. For example, many real estate funds that rely on Section 3(c)(1) or 3(c)(7) also have the ability to rely on Section 3(c)(5)(C).[17]

Similarly, many securitization vehicles may rely on Investment Company Act Rule 3a-7[18] in addition to Section 3(c)(1) or 3(c)(7). Many Private Funds that have the ability to rely on multiple alternative exclusions under the Investment Company Act disclose the alternative exclusions in their offering memorandum and other documentation. It is unclear whether a Private Fund that wants to continue to rely on Section 6(a)(6) or 6(a)(7) as a back-up exception to another available exclusion will have to register and otherwise comply with the new requirements from the inception of the fund or only from the point at which the fund begins to rely on Section 6(a)(6) or 6(a)(7) for its exemption.

EFFECTS ON NON-US FUNDS WITH US INVESTORS

At this point in time, without more in the way of interpretive guidance, the Transparency Act does not, on its face, distinguish in its application as between private investment funds organized in the United States ("US Funds") and those organized outside the United States ("Non-US Funds").

By way of background, Section 7(d) of the Investment Company Act prohibits Non-US Funds from offering or selling their securities in US public offerings unless the SEC issues an order permitting them to register under the Investment Company Act. The standard for issuing such orders requires a Non-US Fund to structure itself and operate as a US investment company. Thus, obtaining an order under Section 7(d) is not a practical alternative for many, if not most, Non-US Funds.

While Section 7(d) prohibits a public offering in the United States by an Non-US Fund, it does not prohibit a US private placement by such a fund. In conducting these sorts of private placements, Non-US Funds may elect to rely on Section 3(c)(1) or 3(c)(7) for their inbound offering (*i.e.*, to US persons). In order for the issuer to rely on Section 3(c)(1) following the offering, the securities of the Non-US Fund may be held by no more than 100 beneficial owners resident in the United States. Similarly, in the context of a Non-US Fund relying on Section 3(c)(7) for its inbound offering, following the offering, all US resident beneficial owners must be qualified purchasers.[19]

Taking all of the above into account, and assuming that the SEC staff determines to use Sections 6(a)(6) and 6(a)(7) as they do Sections 3(c)(1) and 3(c)(7) with respect to inbound offerings by Non-US Funds, Non-US Funds would be subject to similar obligations as US Funds under the Transparency Act.

ANTIFRAUD PROVISIONS

It should be noted that Rule 206(4)-8[20] under the Advisers Act, which already imposes antifraud liability on advisers to Section 3(c)(1) and 3(c)(7) funds, would continue to apply to advisers to Private Funds that rely on Section 6(a)(6) or 6(a)(7). Rule 206(4)-8 prohibits all advisers, whether or not registered under the Advisers Act, from making false and misleading statements to, or otherwise engaging in conduct that is fraudulent, deceptive or manipulative with respect to, investors and prospective investors in certain pooled investment vehicles, without regard to whether a client or prospective client is involved. Thus, the rule prohibits false or misleading statements made, for example, to existing investors in account statements, as well as to prospective investors in private placement memoranda, offering circulars or responses to requests for proposals. The rule applies regardless of whether a pooled investment vehicle is offering, selling or redeeming securities.

FOREIGN CORRUPT PRACTICES ACT

The Transparency Act would not alter the application of the US Foreign Corrupt Practices Act ("FCPA") to private funds. The FCPA broadly prohibits the offering or making of payments or gifts to foreign officials, political parties, political candidates, political party officials, and officials of public international organizations, and also imposes affirmative accounting obligations with respect to corporate books and records and internal controls. These accounting obligations apply only to issuers of securities registered under Section 12 of the Securities Exchange Act of 1934 or to those that file reports under Section 15(d) of that same statute. Since the Transparency Act as currently drafted would not require private funds to register or report under that federal statute, the FCPA accounting obligations would still not apply to private funds. The antibribery provisions of the FCPA, however, apply to any entity organized under US law or with its principal place of business in the United States, so private funds so organized or located are already subject to those provisions, and the Transparency Act would not establish any exemption.

EFFECT ON OPINION PRACTICE

Depending upon the type of Private Fund involved, it is not uncommon for attorneys to be asked by transaction participants as of the closing of a sale of interests in the fund (or in connection with a credit facility) to opine as to the Investment Company Act status of the fund. In the context of Private Funds that currently rely on Section 3(c)(1) or 3(c)(7), the formulation of the typical current opinion would be that the private fund is not an "investment company." If the Transparency Act is enacted, opinions for new Private Funds would need to reference that they are "investment companies" exempt from the provisions of the Investment Company Act other than Sections 6(a)(6) or 6(a)(7).

We note that at this time, passage of the Transparency Act is uncertain. While there appears to be support for this legislation in the current economic environment, even if enacted it could undergo substantial revision beforehand.

Endnotes

1 The Hedge Fund Transparency Act, S. 344, 111th Cong. (2009) (available at http://thomas.loc.gov/cgi-bin/query/z?c111:S.344:). Sen. Grassley's Statement on the Transparency Act (available at http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=19024).

2 Unlike the "hedge fund adviser" registration rule promulgated by the SEC in 2004 ("Registration Under the Advisers Act of Certain Hedge Fund Advisers," SEC Rel. No. IA-2333 (Dec. 2, 2004) (available at http://sec.gov/rules/final/ia-2333.pdf)) and subsequently overturned by a federal appellate court in 2006 (*Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (available at http://pacer.cadc.uscourts.gov/docs/common/opinions/200606/04-1434a.pdf)), the Transparency Act would compel registration of the funds themselves, and possibly their investment advisers. Generally, an adviser cannot qualify for exemption from registration under the Investment Advisers Act of 1940 ("Advisers Act") if the adviser provides advice to a US registered investment company.

3 All references herein to Investment Company Act Section 3 may be found at: http://www.law.uc.edu/CCL/InvCoAct/sec3.html.

4 Full registration as an investment company under the Investment Company Act requires compliance with many investment, disclosure and operational requirements.

5 This is in contrast to the hedge fund adviser registration rule (SEC Rel. No. IA-2333, available at http://sec.gov/rules/final/ia-2333.pdf), which specifically targeted hedge fund advisers by determining the types of investment pools to be covered based on the ease with which investors could withdraw their assets. The rule imposed a bright line between investment pools which had lockup periods of two years or more (which were not covered) from those with lockup periods of less than two years (which were covered).

6 Private Funds and Small Private Funds (as both terms are defined above) which comply with the requirements of Section 6(a)(6) or 6(a)(7) will not need to comply with most of the requirements of the Investment Company Act, such as statutory limits on margin and borrowing, the requirement for independent directors, and the requirement to have a full compliance program. However, it is uncertain at this time whether Private Funds would be required to maintain a compliance manual with respect to their obligations to establish an anti-money laundering program and maintain books and records.

7 As stated in Sections 3(c)(1) and 3(c)(7), such funds are, of course, considered to be investment companies for limited purposes under Section 12 of the Investment Company Act. Under the Transparency Act, Private Funds would continue to be subject to Section 12 to the same extent they are currently under Sections 3(c)(1) and 3(c)(7).

8 It is unclear at this time whether, and how frequently, Private Funds will be required to amend these filings to reflect changes to the statements contained therein.

9 The information form would be filed electronically with the SEC and be publicly available on IDEA (formerly "EDGAR").

10 A similar concern arose several years ago when the SEC began making the Form ADVs of registered investment advisers publicly available on the Internet. Form ADV at the time required disclosure of the social security numbers of all controlling persons of the investment adviser. In response to privacy concerns over the requirement to make this disclosure, the SEC assigns substitute "CRD numbers" in place of the social security numbers. *See* "Electronic Filing by Investment Advisers; Amendments to Form ADV," SEC Rel. No. IA-1897 (Sept. 12, 2000) (available at http://www.sec.gov/rules/final/ia-1897.htm), at n. 11 and accompanying text. It is unclear whether the SEC would take a similar stance here in response to the privacy concerns of the beneficial owners of Private Funds if the Transparency Act is passed.

11 At this time, it is unknown what types of information the SEC staff might determine to request from Private Funds.

12 The Transparency Act does not specify what type of examinations would be required, but exams would presumably be conducted in a fashion similar to the examination of registered investment companies and investment advisers. For an example of the types of information the SEC currently requests during examinations of registered investment advisers, see "Office of Compliance Inspections and Examinations Investment Adviser Examinations: Core Initial Request for Information" (available at http://www.sec.gov/info/cco/requestlistcore1108.htm).

[13] Under current regulations, registered investment companies must implement an anti-money laundering program that includes, among other requirements: written compliance policies, the appointment of an Anti-Money Laundering Officer, annual testing and certification of the program, customer identification procedures that apply to *all* customers and suspicious activity reporting.

[14] See Section 319 of the USA PATRIOT Act (available at http://www.law.cornell.edu/uscode/31/5318.html).

[15] Advisers Act Section 203(b)(3) (available at http://www.law.uc.edu/CCL/InvAdvAct/sec203.html). Investment advisers not otherwise exempt from registration are required to register with the SEC or state regulatory authorities.

[16] Another bill has been introduced in the House which would remove Advisers Act Section 203(b)(3) in its entirety. If this section were removed, any investment adviser with at least one client not qualifying for another exemption would be required to register with the SEC under the Investment Advisers Act or with applicable state securities regulators. Hedge Fund Adviser Registration Act of 2009, H.R. 711, 111th Cong. (2009) (available at http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.711:). A second bill introduced in the House would require the President's Working Group on Financial Markets (the "PWG") to conduct a study on the hedge fund industry and issue a report recommending any regulatory or disclosure requirements the PWG believes should be imposed on hedge funds. Hedge Fund Study Act, H.R. 713, 111th Cong. (2009) (available at http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.713:).

[17] Section 3(c)(5)(C) is available to funds not issuing redeemable securities that are primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. The SEC staff has imposed limitations on what other investments, aside from real estate (*e.g.*, real estate-related investments) may be made by Section 3(c)(5)(C) funds. *See, e.g.*, Burger King Investors Master, LP, SEC No-Action Letter (pub. avail. March 5, 1986). Note that certain other private real estate funds maintain their securities investments at a level which would not cause the fund to be deemed an investment company under the tests included in Section 3(a) of the Investment Company Act, but they nevertheless preserve their ability to rely on Section 3(c)(1) or 3(c)(7) as an alternative to complying with the Section 3(a) threshholds.

[18] Investment Company Act Rule 3a-7 (available at http://www.law.uc.edu/CCL/InvCoRls/rule3a-7.html).

[19] It should be noted that there are a myriad of rules and SEC staff interpretations that add gloss to whom must be viewed as a beneficial owner and other related matters (such as the obligation to track US beneficial owners), but those concepts are not covered here.

[20] Advisers Act Rule 206(4)-8 (available at http://www.law.uc.edu/CCL/InvAdvRls/rule206(4)-8.html).

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