

February 2009

Private Investment Fund Legislation Introduced in House

On January 27, 2009, Representatives Michael Capuano (D-Massachusetts) and Michael Castle (R-Delaware) introduced a package of legislation in the U.S. House of Representatives that would result in significant changes in the oversight of private investment funds (such as hedge funds, private equity funds and venture capital funds). The legislation includes the “Hedge Fund Adviser Registration Act of 2009” (H.R. 711), the “Pension Security Act of 2009” (H.R. 712), and the “Hedge Fund Study Act” (H.R. 713), each discussed in more detail below. This House legislation package is separate and distinct from legislation recently introduced in the Senate (S. 344) by Senators Chuck Grassley (R-Iowa) and Carl Levin (D-Michigan), which would amend the Investment Company Act of 1940 to require the registration of many investment funds as “investment companies.” A copy of our update on S. 344 is available [here](#). Copies of H.R. 711, H.R. 712 and H.R. 713 are available by clicking below.

[H.R. 711](#)

[H.R. 712](#)

[H.R. 713](#)

Hedge Fund Adviser Registration Act of 2009 (H.R. 711)

Many private investment fund managers avoid registration under the Investment Advisers Act by relying on the private adviser exemption provided in Section 203(b)(3) and Rule 203(b)(3)-1 of the Advisers Act (also known as the “15 client” exemption). Under this exemption, an investment adviser is exempt from registration with the SEC under the Advisers Act if (i) it had fewer than 15 clients during the preceding 12 months, (ii) it does not hold itself out generally to the public as an investment adviser, and (iii) it does not act as an investment adviser to a registered investment company. Under the client counting rules of Rule 203(b)(3)-1, a private investment fund generally is counted as a single “client” even though the fund itself may have a much larger number of investors.

H.R. 711, if enacted in its current form, would entirely eliminate the 15 client exemption. While Representative Capuano addressed the impact of this legislation on “hedge funds” in his press release regarding the legislation, this exemption is relied on by advisers to all types of private investment funds. As a result, if H.R. 711 is enacted, the general partners and managers of private equity funds, venture capital funds and other types of funds, as well

as hedge funds, would be required to register with the SEC under the Advisers Act and would be subject to additional regulation and oversight.

In contrast to the Hedge Fund Transparency Act (S. 344), H.R. 711 focuses on the registration and oversight of the advisers to the funds as opposed to the funds themselves. Fund advisers have been the target of previous efforts at regulation by the SEC and Congress. The SEC’s Rule 203(b)(3)-2 under the Advisers Act required certain private investment fund managers to register under the Advisers Act by forcing the advisers to “look-through” their managed funds to the individual investors and count each individual fund investor as a client for purposes of the 15 client exemption. In 2006, this so-called “Hedge Fund Rule” was vacated and remanded by the U.S. Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC* as arbitrary and impermissible. Notably, the “Hedge Fund Rule” only required look-through counting of clients if the underlying fund permitted withdrawal or redemption during the first two years after the interest in the fund was acquired. As a result, many hedge fund managers registered under the Advisers Act and became familiar with the Advisers Act regulatory structure, while advisers to private equity

funds and other funds with longer term lock ups largely avoided registration.

Although general partners and managers to private investment funds are already subject to the antifraud rules of the Advisers Act, if they are required to register as investment advisers, they will become subject to all provisions of the Advisers Act, including its rules relating to client asset custody, recordkeeping, advisory contracts, ethics and personal trading policies, investment and financial reporting, and advertising. Of particular note is the prohibition on registered investment advisers charging client fees based on portfolio or fund performance unless such client is a “qualified client” (a person with at least \$750,000 under management with the adviser or with a net worth of at least \$1.5 million). Funds that avoid registration with the SEC under the Investment Company Act by relying on the “less than 100 beneficial owners” exception in Section 3(c)(1) may have investors that do not meet the definition of a “qualified client.” If the 15 client exemption is eliminated, a general partner or manager to such a Section 3(c)(1) fund would be prohibited from charging a performance-based fee, such as carried interest, to those investors who did not meet the “qualified client” definition.

Pension Security Act of 2009 (H.R. 712)

H.R. 712 would amend Section 103(b) of the Employee Retirement Income Security Act of 1974 (ERISA) to add a new requirement that defined benefit pension plans disclose in their annual report each “hedge fund” in which they invest as well as the amount invested in such hedge fund.

For purposes of this provision, “hedge funds” would include unregistered investment pools permitted under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act and Section 4(2) of the Securities Act of 1933 and Rule 506 of Regulation D thereunder. Since most private equity funds and venture capital funds also rely on the exceptions to the Investment Company Act found in Sections 3(c)(1) or 3(c)(7) and the Section 4(2) / Rule 506 private placement exemptions, this proposed legislation would impact a broader group of private investment funds than just hedge funds.

If enacted, the amendment in H.R. 712 would apply to annual reports for plan years beginning on or after the date of enactment. The Secretary of Labor, in consultation with the SEC, must issue initial regulations to carry out the amendments no later than one year after the date of enactment.

The reporting and disclosure obligations of ERISA-governed employee benefit plans have been significantly increased within the last few years with mandates under the Pension Protection Act of 2006 and recent Department of Labor guidance. This “hedge fund” reporting obligation, if enacted, would add yet another obligation of which plans must be aware and with which they must comply.

The Pension Protection Act of 2006 fostered investment by ERISA plans in hedge funds and other investment funds by limiting the types of benefit plan investors that are included in the 25% test to determine whether benefit plan participation is “significant,” making it easier for funds to perfect exemption from the plan asset regulations.

Hedge Fund Study Act (H.R. 713)

H.R. 713 would direct the President’s Working Group on Financial Markets to conduct a study of the hedge fund industry and submit a report and recommendations to the House Financial Services Committee and the Senate Banking, Housing and Urban Affairs Committee no later than 180 days after enactment.

The study must include an analysis of:

- the changing nature of hedge funds and what characteristics define a hedge fund;
- the growth of hedge funds within financial markets;
- the growth of pension funds investing in hedge funds;
- whether hedge fund investors are able to protect themselves adequately from the risk associated with their investments;
- whether hedge fund leverage is effectively constrained;
- the potential risks hedge funds pose to financial markets or investors;
- various international approaches to the regulation of hedge funds; and
- the benefits of the hedge fund industry to the economy and the markets.

The recommendations must include:

- any proposed legislation relating to appropriate disclosure requirements for hedge funds;

- the type of information hedge funds should disclose to regulators and to the public;
- any efforts the hedge fund industry or regulators of financial institutions should undertake to improve practices or provide examples of successful industry initiatives; and
- any oversight responsibilities that members of the President's Working Group should have over the hedge fund industry, and the degree and scope of such oversight.

Conclusion

H.R. 711 and H.R. 713 have been referred to the House Financial Services Committee for review and H.R. 712 has been referred to the House Education and Labor Committee (although committee action is not necessarily required

before the bills could be acted upon or attached to other legislation). We expect this legislation or similar legislation impacting private investment funds will receive significant attention since Representatives Capuano and Castle are members of the House Financial Services Committee, whose Chairman Barney Frank (D-Massachusetts), along with Senate Banking Committee Chairman Chris Dodd (D-Connecticut), has indicated plans to undertake financial industry regulatory overhaul and oversight proposals in the coming year. This legislation, and similar legislation such as S. 344 in the Senate, would result in sweeping changes in the oversight of private investment funds and the public disclosure required of certain benefit plan investors in those funds.

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.

Additionally, Chairman Frank and Chairman Dodd have indicated their desire to seek information and input from the industries impacted by the various oversight and reform proposals. The Hunton & Williams Government Relations team is equipped with the know-how and relationships to assist you in outreach to Congress if you would like to discuss your concerns regarding, and/or offer alternatives to, the proposed legislation.

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