Further Thoughts on Pending Private Fund Transparency Initiatives

In our firm memorandum of February 2, 2009,[1] we discussed certain ramifications of the "Hedge Fund Transparency Act of 2009" ("HFTA"), a bill introduced on the Senate floor on January 29th and currently under consideration by the Senate Banking Committee. In light of the nearly contemporaneous introduction on the House floor of the "Hedge Fund Adviser Registration Act of 2009" ("HFARA"),[2] we offer these further observations on these initiatives intended to extend Securities and Exchange Commission ("SEC") regulatory oversight to private investment vehicles and their investment advisers.

I. Implications of HFARA for Investment Adviser Registration

Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Advisers Act") provides an exemption from SEC registration for any investment adviser who "during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under title I of this Act."[3] The operative language of HFARA reads in its totality as follows: "Section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3) is amended by striking subsection (b)(3)." Thus, if enacted, this exemption from Advisers Act registration -- which has been part of the Advisers Act for many years[4] and has been relied upon by countless investment advisers-- would be eliminated.

The impact of such a change could be significant. Many investment advisers rely on the Section 203(b)(3) exemption from registration and limit the number of their advisory clients to fewer than 15 and/or limit their business to investment pools which are exempt from registration under the Company Act.[5] Without the benefit of Section 203(b)(3), only relatively small advisory businesses that advise individuals and have less than $30 million of assets under management will be exempt from federal registration.[6]

In 2004, the SEC attempted to assert its regulatory jurisdiction over investment advisers of private investment funds. At that time, the SEC promulgated a rule which required an investment adviser to look through

1 Available at http://www.cahill.com/news/memoranda/000147/_res/id=sa_File1/Registration%20of%20Private%20Investment%20Companies%20Proposed%20in%20Senate%20Bill.pdf

2 H.R. 711, available at http://www.govtrack.us/congress/billtext.xpd?bill=h111-711

3 The reference to "title I of this Act" in Section 203(b)(3) of the Advisers Act is a reference to the Investment Company Act of 1940 (the "Company Act").

4 The "fewer than fifteen clients" clause has been part of the Advisers Act since it was enacted in August 1940. The language requiring registration if a firm is an investment adviser to a registered investment company was added to the statute by amendments enacted in 1970.

5 Advisers Act Rule 203(b)(3)-1 permits an investment adviser to count a private fund as one client provided, among other things, the private fund does not permit its investors to redeem their ownership interests within two years of purchasing such interests.

6 Pursuant to Advisers Act Rule 203A-1, SEC registration under the Adviser Act is not triggered until an investment adviser, having a principal office in a state with an investment adviser statute, has at least $30 million under management (pre-empting state registration). Below that dollar threshold, an investment adviser having a principal office in a state with an investment adviser statute may opt to register federally (pre-empting state registration) if it has at least $25 million, but less than $30 million, under management; and, if it has below $25 million under management, it need only look to state securities laws for any applicable registration requirements.

a private investment fund and count the number of investors in that fund for purposes of the "fewer than 15 clients" safe harbor in Section 203(b)(3). If the investment adviser managed a private investment fund having 15 or more investors, the investment adviser's registration requirement was triggered.[7] In June 2006, the Court of Appeals for the District of Columbia unanimously held in *Goldstein* v. *SEC*[8] that the SEC rule was arbitrary and unreasonable, and vacated the rule. If enacted, HFARA would undo the effect of *Goldstein* and reestablish SEC regulatory oversight of investment advisers presently exempt from registration.

II. Further Thoughts on HFTA

A. Potential Impact on Adviser Registration

The enactment of HFARA could have a sweeping impact on a wide variety of investment advisers. However even if it is not enacted, investment advisers that limit their clients to private investment funds may still find themselves required to register under the Advisers Act if HFTA is enacted.

By moving Sections 3(c)(1) and 3(c)(7) out of Section 3 of the Company Act, companies relying on those exemptions would no longer be carved out the Act's definition of "investment company." Rather, by placing those exemptions in Section 6 of the Act, such companies would be considered "investment companies" and simply be exempted from most of the provisions of the Act, as discussed in our prior memorandum.

For a private investment fund with $50 million or more under management, one condition for relying on either of the statutory exemptions would be that it register with the SEC under the Company Act. Under Section 203(b)(3) of the Advisers Act, an investment adviser to an investment company registered under the Company Act, must register under the Advisers Act. So even if Section 203(b)(3) were not stricken from the Adviser Act by HFARA, the enactment of HFTA could trigger Advisers Act registration for any adviser to a private fund with $50 million or more under management.

B. Ownership Attribution Analysis Expanded[9]

HFTA would also expand the present "ownership attribution" rule that is now part of Section 3(c)(1). This element of HFTA could severely limit the ability of private funds relying on the 100 securityholder exemption from investing in other private investment funds.

At present, a fund which does not, or does not propose to offer its securities publicly, can rely on the 100 securityholder exemption so long as it limits the number of beneficial owners of its securities to not more than one hundred. Beneficial ownership of a fund's securities by a company shall be deemed to be beneficial ownership by one person for purposes of counting the number of the fund's securityholders, except that, if such beneficial owner is itself relying on the 100 securityholder exemption or qualified purchaser exemption and owns 10 percent or more of the outstanding voting securities of the fund, beneficial ownership of the fund's securities is attributed to the holders of such company's securities — the so-called "attribution" analysis.

---

[7] *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Release No. IA-2333 (Dec. 10, 2004) available at http://www.sec.gov/rules/final/ia-2333.htm adopting Rule 203(b)(3)-2.

[8] 451 F.3d 873 (D.C. Cir. 2006).

[9] Herein, the exemption in Section 3(c)(1) and its potential successor provision, Section 6(a)(6), is referred to as the "100 securityholder exemption" and the exemption in Section 3(c)(7) and its potential successor section, Section 6(a)(7), is referred to as the "qualified purchaser exemption."

There is no similar "attribution" provision in the Company Act qualified purchaser exemption, although under Rule 2a51-3, if a company is formed for the "specific purpose" of investing in a Section 3(c)(7) company then all of the investors in the newly formed company must be "qualified purchasers." A private fund that has not been formed for such specific purpose, including a fund relying on the 100 securityholder exemption that meets the requirements of the qualified purchaser definition,[10] is eligible to invest in a fund relying on Section 3(c)(7).

HFTA would expand the existing statutory "attribution" analysis by providing that any issuer that is otherwise exempt from the provisions of the Company Act by reason of either the 100 securityholder or qualified purchaser exemption will not be treated as a single issuer with respect to any other issuer relying on one of those exemptions in which they are an investor. As for companies relying on the 100 securityholder exemption, this new provision would seem to make irrelevant the additional requirement that ownership of 10 percent or more of a company's voting securities would be necessary to trigger an attribution analysis.

In the case of a company relying on the qualified purchaser exemption which has an exempt investment fund as one of its investors, it would have to look through such an investor to assure itself that each of such fund's securityholders was a qualified purchaser. One result of this regulatory framework would be that a company relying on the 100 securityholder exemption would not itself be eligible to be a qualified purchaser for purposes of investing in another fund relying the qualified purchaser exemption, unless each of the investor fund's securityholders was a qualified purchaser.

III. Conclusion

These proposed pieces of legislation will have myriad consequences, intended and unintended, if they are adopted as proposed. Considerable clarification as to how they would be applied and implemented will be required. As one example of this need, Senator Carl Levin, one of the co-sponsors of HFTA, has already issued a press release in which he sought to clarify one of the provisions of that bill. In his release he stated "that it was not the intention of HFTA to require disclosure of hedge fund clients who merely invest in the fund. Instead the bill requires disclosure of a hedge fund's beneficial owners, who profit from the fees generated in operating the fund... [A]ny interpretation or characterization of our bill as requiring hedge funds to disclose their clients' names is incorrect."[11] It is assumed that Senator Levin was seeking to clarify language in the bill which would require disclosure of the names of the natural persons and companies with beneficial ownership interests in companies required to file forms with the SEC as a condition to relying on the exemption provisions.

---

[10] A "qualified purchaser" is defined (in Section 2(a)(51)) to mean a natural person who owns not less than $5 million in investments, as defined by the SEC; a company that owns not less than $5 million in investments that is owned by two or more natural persons who are related as siblings or spouse, as lineal descendants or trusts for such persons; a trust not formed for the purpose of acquiring the securities offered as to which the trustee is a person owning not less than $5 million in investments; a person who for its own account or for others owns and invests not less than $25 million in investments. The term does not include a "private investment" company that acquired securities on or before April 30, 1996 unless all of the beneficial owners of securities have consented to the company's treatment as a qualified purchaser. Under Rule 2a51-1, any person who is a qualified institutional buyer, as defined in Rule 144A, is also deemed a qualified purchaser, except that if the entity is a dealer described in Rule 144A it must own and invest on a discretionary basis at least $25 million (Rule 144A only requires $10 million) in securities of non-affiliates; and, a plan referred to in Rule 144A will not be deemed to be acting on its own account if investment decisions are made by beneficiaries of the plan except with respect to investment decisions made solely by the fiduciary of the plan.

[11] Senator Carl Levin, Press Release dated February 5, 2009 available at http://levin.senate.gov/newsroom/release.cfm?id=307821.

Given the potential influence these initiatives would have on the operations of hedge funds, private equity funds and other alternative investment vehicles, and their investment advisers, we will be closely monitoring their status as they travel through Congress.

* * *

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com

This memorandum is for general information purposes only and is not intended to advertise our services, solicit clients or represent our legal advice.