

Isaac Lustgarten
Occam Regulatory Solutions LLC
225 East 57th Street, Suite 2F
New York, New York 10022

917 209 8709
ilustgarten@occamregolutions.com

Hedge Fund Transparency Bill Does Not Address Systematic Risks

The Hedge Fund Transparency Act of 2009 would clarify current law to remove any doubt that the Securities and Exchange Commission has the authority to require hedge funds to register. It would close the loophole previously used by hedge funds to escape the definition of an “investment company” under the Investment Company Act of 1940. Hedge funds that want to avoid the requirements of the Investment Company Act would be exempt only if they file basic disclosure forms and cooperate with requests for information from the Securities and Exchange Commission.

Background: While a previous bill amended the Investment Advisers Act of 1940, this bill amends the Investment Company Act of 1940 (“ICA”).

Gap in the Bill: The most significant weakness in the bill is that it fails to address systematic risks posed by hedge funds. Many hedge fund managers now support the idea of a legal requirement to frequently disclose risk positions to a government regulator or private entity that would aggravate and mask the information it discloses to others. Actual positions and strategies would not be disclosed to competitors. The regulator would have sufficient information to detect asset bubbles, excessive activity in certain products and correlation risks.

Hedge Fund Registration Requirements

Definition of an Investment Company: Hedge Funds typically avoid regulatory requirements by claiming the exceptions to the definition of an investment company contained in §3(c)(1) or §3(c)(7) of the ICA. This bill would remove those exceptions to the definition, transforming them to exemptions by moving the provisions, without substantive change, to new sections §6(a)(6) and §6(a)(7) of the ICA.

Requirements for Exemptions: An investment company that satisfies either §6(a)(6) or §6(a)(7) will be exempted from the normal registration and filing requirements of the ICA. Instead, a company that meets the criteria in §6(a)(6) or §6(a)(7) but has assets under management of \$50,000,000 or more, must meet several requirements in order to maintain its exemption.

These requirements include:

- 1. Registering with the SEC.
- 2. Maintaining books and records that the SEC may require.
- 3. Cooperating with any request by the SEC for information or examination.
- 4. Filing an information form with the SEC electronically, at least once a year. This form must be made freely available to the public in an electronic, searchable format.

The form must include:

- a. The name and current address of each individual who is a beneficial owner of the investment company.
- b. The name and current address of any company with an ownership interest in the investment company.
- c. An explanation of the structure of ownership interests in the investment company.
- d. Information on any affiliation with another financial institution.
- e. The name and current address of the investment company's primary accountant and primary broker.
- f. A statement of any minimum investment commitment required of a limited partner, member, or investor.
- g. The total number of any limited partners, members, or other investors.
- h. The current value of the assets of the company and the assets under management by the company.

Timeframe and Rulemaking Authority: The SEC must issue forms and guidance to carry out this Act within 180 days after its enactment. The SEC also has the authority to make a rule to carry out this Act.

Anti-Money Laundering Obligations: An investment company exempt under §6(a)(6) or §6(a)(7) must establish an anti-money laundering program and report suspicious transactions under 31 U.S.C.A 5318(g) and (h). The Treasury Secretary must establish a rule within 180 days of the enactment of the Act setting forth minimum requirements for the anti-money laundering programs. The rule must require exempted investment companies 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." The rule must also require exempted investment companies to comply with the same

requirements as other financial institutions for producing records requested by a federal regulator under 31 U.S.C. 5318(k)(2).

Issues:

Hedge fund is not defined, and the bill would apply to all investment vehicles that were previously relying on Section 3(c)(1) or 3(c)(7) of the 1940 Act. This includes many types of pooled investment vehicles such as private equity funds, venture capital funds, distressed debt funds and certain financial product vehicles, in addition to funds that are commonly referred to as hedge funds.

The annual reporting of names and addresses purports to require disclosure of all owners of the investment company. No other provision of the federal securities laws requires disclosure of the names of persons who make insignificant, passive investments in an investment vehicle. Moreover, it is difficult to see how public disclosure of this information advances the governmental interest in improving oversight by a regulatory agency of systemic risk.

The reach of the bill and its application to non-US funds with US investors, is unclear.

It is unclear how the books and records and SEC examination requirements of HFTA - that would be imposed on the funds themselves - would interact with the Advisers Act's requirements applicable to registered investment managers.

The bill leaves open the question of whether the Financial Industry Regulatory Authority (FINRA) or some other "self-regulatory organization" will have examination responsibilities with respect to managers or hedge funds.

The AML obligations would become self-executing and enforceable one year after the effective date of the Act even if Treasury does not issue a final rule. This new provision may have been included in response to Treasury's suggestion, when withdrawing its proposed AML program rule, that it may not impose BSA requirements on unregistered investment companies.