



Private Equity Alert

Developments in private equity law

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Hedge Fund Transparency Act would eliminate Sections 3(c)(1) and 3(c)(7) of the Investment Company Act

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On January 29, 2009, Senators Charles Grassley (R-Iowa) and Carl Levin (D-Michigan) introduced the Hedge Fund Transparency Act (S. 334). The bill would delete Sections 3(c)(1) and 3(c)(7) from the Investment Company Act of 1940, thereby bringing within the definition of an “investment company” those entities that, because they have 100 or fewer beneficial owners (“3(c)(1) funds”), or because all of their equity securities are owned by “qualified purchasers” (“3(c)(7) funds”), have heretofore been excluded. According to the statements released by the sponsors upon introduction of the bill, this definitional change is intended to address the 2006 *Goldstein* decision of the U.S. Court of Appeals for the D.C. Circuit, which held that efforts by the SEC to regulate hedge funds and hedge fund managers went beyond the Commission’s statutory authority.

Under the bill, entities that previously qualified as 3(c)(1) or 3(c)(7) funds would now be investment companies subject to the SEC’s regulatory authority. The bill provides for exemption of such entities from the normal registration and filing requirements of the Investment Company Act. However, the bill imposes a severe condition on the availability of such exemption to entities that it characterizes as “large investment companies” (entities with assets of \$50 million or more), requiring such entities to register with the SEC and to file annual reports with the SEC that, among other things, will disclose the names and addresses of all of their beneficial owners (including limited partner investors), as well as “the current value” of the fund’s assets. None of the SEC’s other regulatory programs (including regulations governing mutual funds and other registered investment companies) requires a reporting entity to disclose the names and addresses of all of its investors. As a result, the bill could discourage many traditional hedge fund investors, such as wealthy individuals, retirement funds, and endowments, that want to keep their investments private from investing in this asset class.

The bill’s title and the sponsors’ statements refer to “hedge funds” as the subject of the new legislation, but the language of the bill is significantly more sweeping. Venture capital funds, private equity funds, and funds-of-funds have all relied on Sections 3(c)(1) and 3(c)(7) to avoid investment company status, and the elimination of these provisions of the Investment

Company Act throws those funds into the same new regulatory scheme as hedge funds. Indeed, as drafted, the bill may restrict the ability of a fund-of-funds to continue to operate, since the Investment Company Act imposes severe restrictions on the ability of registered investment companies to invest in other investment companies.

At the very least, unless the bill's definition of "large investment companies" is revised to exclude funds that invest in private equity, or similar relief is provided to such funds, most venture capital funds, private equity funds, and funds-of-funds will be required to register with the SEC and to make the mandated annual disclosures. In addition to subjecting such funds to the obligation to make the identity of their investors public, the bill could require such funds (whose portfolios consist largely of illiquid securities and whose holdings seldom have a readily determinable fair market value) to expend significant resources on annual portfolio valuations.

Although, in his introductory statement, Senator Levin acknowledged that the bill would apply to the full range of investment funds, commentators are already suggesting that the bill's language may be altered so as not to impose undue burdens of registration and disclosure on venture capital funds, private equity funds, funds-of-funds, and similar private entities that do not invest in the public market. Regardless of the ultimate scope of the bill's registration and reporting requirements, it is highly likely that, in addressing the regulation of hedge funds, Congress will confirm the SEC's authority to regulate the entire spectrum of pooled investment entities (including private equity funds) and their managers.

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