

The Hedge Fund Transparency Act of 2009
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A bill that Senators Charles Grassley (R-Iowa) and Carl Levin (D-Mich.), the Hedge Fund Transparency Act of 2009 (the “*Transparency Bill*”) introduced in the Senate last week would impose certain registration and disclosure requirements on hedge funds and certain other private funds. The bill would primarily affect funds having more than \$50 million in assets (deemed “large” investment companies) that meet the requirements of Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 to avoid being deemed an “investment company” required to register as such under that Act.

If enacted, the Transparency Bill would require those “large” investment funds to “register with” the SEC, maintain whatever books and records the SEC may require, and comply with the SEC’s requests for information or examination. In addition, the Transparency Bill would require each of those funds to file certain information with the SEC on an annual basis, including information regarding the identity (including addresses) of the fund’s “beneficial owners,” the amount of the fund’s assets, the fund’s equity structure, affiliations the fund may have with other financial institutions, the minimum investment commitment required of investors, and the total number of investors. All of this information would be publicly available and searchable.

The Transparency Bill would also subject *all* private funds, regardless of asset size, to certain requirements relating to the detection and prevention of money laundering, including a requirement to establish anti-money laundering programs.¹

Because the Transparency Bill would cover all “3(c)(1)” and “3(c)(7)” funds, it would encompass within its purview not only so-called “hedge” funds, but also venture capital and other private equity funds, and special-purpose structured finance entities. However, as the Transparency Bill’s name indicates, hedge funds are the Bill’s primary targets.

In their floor statements introducing the Transparency Bill, Senators Grassley and Levin each suggested that the Bill is a version, or an extension, of the SEC’s attempt in 2004 to require certain investment advisers to private funds — namely, hedge fund managers — to become registered with the SEC under the Investment Advisers Act of 1940, the companion statute of the Investment Company Act. The SEC’s rule had eliminated an exemption to investment adviser registration that had been available to advisers that managed fewer than 15 hedge funds. With the D.C. Circuit Court of Appeals’ vacating the rule in 2006 on the basis that the SEC’s adoption of it was beyond the SEC’s rulemaking authority, it was left to Congress to require that registration. And, in 2007, Senator Grassley had proposed a bill

¹ Most types of financial institutions have been subject to similar requirements for years, but the U.S. Department of Treasury in October 2008 withdrew regulations that it had proposed in 2002 that, if adopted, would have covered unregistered investment companies (such as hedge funds).

that would have accomplished what the SEC had tried to do — require hedge fund managers to become registered as investment advisers under the Investment Act.²

The Transparency Bill, however, is different in kind from that and subsequent recent attempts to subject hedge funds to greater federal oversight. Rather than require hedge fund managers to register as investment advisers under the Investment Advisers Act, the Transparency Bill would subject *hedge funds themselves* to registration and disclosure requirements.³ Specifically, whereas the Investment Company Act currently excludes hedge funds from the definition of “investment company,” the Transparency Bill would bring hedge funds within that definition but continue to exempt them from the full panoply of regulatory requirements to which mutual funds and other retail investment funds are subject. Under at least the terms of the Transparency Bill, hedge fund managers, would not themselves need to become registered with the SEC.⁴

Accordingly, the Transparency Bill has shifted the regulatory focus from hedge fund managers to hedge funds themselves, and the repository of that regulation from the Investment Advisers Act to the Investment Company Act. Although not apparent in the Bill’s text, the shift may stem from the heightened concern among regulators that large hedge funds create systemic risk. That is, regulators and commentators have expressed concern that, with the increasing complexity of the financial markets and hedge funds’ pervasive role in those markets, counterparties and regulators should know more about hedge funds’ investment positions and their concentrations—and the extent to which those positions embody or were obtained with leverage—so that market participants may better manage their own risk, thereby reducing the risk that financial crises will occur.⁵ Indeed, Senators Grassley and Levin expressly connected their introduction of the Transparency Bill on the need for a regulatory response to the ongoing financial crisis and, in particular, hedge funds’ perceived role in that crisis.

The goal of reducing systemic risk may be distinguished from the objectives guiding the SEC’s 2004 attempt to regulate hedge fund managers, which was largely predicated on the

²See Hedge Fund Registration Act of 2007, S. 1402, 110th Cong. (2007). The Senate did not consider that bill.

³ The Transparency Bill’s focus on funds, rather than managers, renders inappropriate some of its own terminology. In particular, one of the items that a fund would need to report to the SEC annually is its “assets, or assets under management.” Funds are pools of capital, not investment managers. Accordingly, although a fund may be expected to have a certain amount of assets, it should not have “assets *under management*,” a phrase that is appropriate instead for describing a fund *manager*.

⁴ However, under the Investment Advisers Act, any adviser to an investment company registered under the Investment Company Act must become registered as an investment adviser with the SEC. Accordingly, if Congress deems large hedge funds’ compliance with the Transparency Bill’s requirements to constitute “registration,” hedge fund managers to those funds will be required to become registered as investment advisers under the Investment Advisers Act.

⁵ The argument has obtained further momentum by virtue of hedge funds’ participating in some of the riskiest and complex instruments in the markets.

notion that hedge fund managers and their investment tactics posed risk to investors in the funds they manage. If detecting and reducing fraud is the goal, making fund managers the focus of new regulation would seem a reasonable approach for furthering it, at least in comparison to focusing on hedge funds themselves. By contrast, as noted above, in the context of recent market tumult and worldwide financial crises, regulators have focused more aggressively on the effects of the activities that large hedge funds pursue in their day-to-day operations. Given that focus, the actual market participants whose activities are seen as creating systemic risk — hedge funds, rather than their managers — may seem the more appropriate regulatory subject.⁶

If hedge funds' activities do threaten systemic stability to the extent that regulation is needed to mitigate that risk, it remains a question whether the Transparency Bill will serve that end. The Transparency Bill's disclosure requirements respond to widespread sentiment that hedge funds' activities should be subject to heightened requirements for information disclosure. And, from a systemic risk perspective, information about particular investment positions and leverage employed to obtain those positions is presumably the type of information that would help permit regulators to determine whether a hedge fund's activities, whether taken alone or in combination with the activities of other market participants, pose risks to the markets generally and how great those risks are. By its terms, of course, the Transparency Bill would not require hedge funds to disclose that type of information. However, perhaps most important among the Bill's provisions is the apparent authority it grants the SEC to obtain from hedge funds information the SEC deems appropriate to obtain — which presumably could include portfolio holdings information.

If the SEC were to exercise that authority, would it achieve any additional protection for the financial markets, and, if so, at what price? It may be that for information about hedge funds' activities to help the SEC or other analysts accurately assess the risks posed by funds' investment activities, the SEC would need also to obtain similar information from other market participants, such as banking institutions. As yet, however, no comprehensive scheme to obtain that information has been proposed.

Other concerns would arise if that type of information, as with other information that private funds will be required to submit periodically to the SEC, were to be publicly available. In particular, if it would be possible for information that the SEC requests through its authority under the Transparency Bill to be made public, whether as a result of the SEC's disclosure or as a result of FOIA requests, there would arise the risk that disclosure may affect hedge fund investment activities in a manner that could hinder funds' role in financial markets as liquidity providers and sources of capital. Fund managers may cease to have sufficient incentives to continue fund strategies and activities that they can no longer keep proprietary.

⁶ An additional indication the regulators may be focused more on reducing systemic risk than protecting investors is the Transparency Bill's requirement that large private funds disclose the names and addresses of their investors. This requirement appears to be directly contrary to other requirements under federal law that financial institutions (deemed to include investment funds) implement procedures to ensure the protection of "customers'" (which would include investors') nonpublic personal information.

Accordingly, if transparency requirements are to further regulators' goals without unduly stifling investment innovation and entrepreneurship, arguably additional data is necessary to formulate those requirements. Ideally that data would help answer a variety of questions: What would be the effects of disclosure on hedge fund investment activities? Would the SEC adequately be able to assess that information without obtaining similar information from all market participants? Does the SEC have the tools and sophistication to properly evaluate the information — to assess risks — and take appropriate action on the basis of it? And what actions should regulators take if and when they detect systemic risk? The Transparency Bill implicates these additional policy questions, and as the Bill works its way through Congress, answering these questions should be a priority.

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