

Corpsec Hotline

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US SEC PUTS A NOOSE AROUND PRIVATE FUNDS INVOLVING INVESTMENTS BY US INVESTORS

Global meltdown, falling markets, detrimental carried interest taxation, limited partner defaults, and now a possibility of getting caught in the regulatory web. On January 29, 2009, Senators Chuck Grassley and Carl Levin introduced in the United States Senate, the Hedge Fund Transparency Act (the “**Act**”) which is aimed at putting a lasso on the largely unregulated private funds industry. The legislative bill, if enacted, would bring in far reaching changes to the funds industry. The Act may, apart from funds, also bring regulatory shy investment advisors and managers within the regulatory purview of the Securities Exchange Commission (“**SEC**”).

Till now, hedge funds typically avoid regulatory requirements by claiming the exceptions to the definition of an investment company contained in sections 3(c) (1) and 3(c)(7) of the Investment Company Act, 1940 (“**ICA**”). However, this freedom would now be significantly curtailed by the Act, which is aimed at regulating all private funds including hedge funds, private equity funds, venture capital funds, real estate/infrastructure funds etc. which are being marketed to U.S. investors. Apart from registration requirements, the Act also provides for establishing anti-money laundering programs and reporting suspicious transactions.

Further, the Act will be applicable to all private funds, irrespective of their jurisdiction, which could be Cayman, Mauritius, India, EU, anywhere. As long as a private fund has US investors, it will come within the scope of the proposal. Lately, this is the second development which has seen the US fund industry going through a change in legal regime, which may have an adverse impact on this industry. This bill was preceded by tax proposals being announced by US President Obama to tax carried interest received by fund managers at a higher rate.

Registration Requirements

The Act would deem a private fund which has USD 50 million or more of assets under management, to be deemed an “**investment company**” under the ICA and exempted under section 8 of the ICA, only if such private fund:

1. Registers with the SEC
2. Files an information form with the SEC every year
3. Maintains such books and records as may be required by the SEC
4. Co-operates with any request for information or examination by the SEC
5. Adopts, implements and maintains anti-money laundering program

Disclosure Requirements

Further, the information form which will be required to be filed with the SEC every year would contain, inter alia:

1. Structure of ownership interest in the private fund
2. Name and address of each natural person who is a beneficial owner of the private fund
3. Name and address of any company with an ownership interest in the private fund
4. Total number of investors
5. Information about financial institution affiliates of the private fund
6. Statement of any minimum investment commitment required of investors
7. Current value of the assets held by the private fund and the assets under management

Anti-Money Laundering Program

To safeguard against financing of terrorist organizations and money laundering, private funds required for registration under the Act may also be required to establish and implement a written anti-money laundering program. 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. Section 4 of the Act also requires that the program “*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.*”

Consequences

If the Act sees the light of the day, the most far reaching and important consequence will be that any fund regardless of the jurisdiction with a size greater than USD 50 million and marketed to U.S. investors may require compulsory

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Further, if private funds fail to meet any of the requirements as detailed above, then they may be required to be registered under section 8 of the ICA. We understand that the registration requirements and the continuing obligations under the ICA are quite onerous and many funds may not want to be fully regulated. Compulsory registration of private funds may also lead to many investor drawbacks and thereby leading the fund managers to close the fund.

It will also be interesting to see whether the Act would cover the following scenarios:

- Indian mutual funds which may be marketed to U.S. investors.
- Funds listed in other jurisdictions in which a U.S. investor may invest, though it may not be marketed directly.
- A U.S. based fund/entity investing into an Indian fund and whether such Indian fund would require registration under the Act.

Conclusion

The global financial meltdown has created a profound shift in general opinion towards the funds industry. The days of the hedge fund industry operating outside of the "watchful" eye of regulators are coming to an end. This current financial meltdown has swung the pendulum to the other extreme where the regulators are looking to regulate everything. Such an outlook of the regulators may stifle the growth of the funds industry and may make it more difficult for private funds to come out of the recession. While it is imperative that certain checks and balances are introduced through regulations, it is also important to maintain the balance between the need to regulate and the manner and extent of regulations. Whether this act by the U.S. government impacts the views of the Indian regulators is still to be seen. The Securities and Exchange Board of India ("SEBI") had already conceptualized the investment advisor regulations, which they introduced for public comments in 2007, but they have still not come out with the formal regulations. SEBI may take a cue from this development and may speed up their process to come out with formal regulations governing the registration of investment advisors in India and any other unregistered and unregulated entities.

- Divaspati Singh & Parul Jain

You can direct your queries or comments to the authors

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