



A Critical Look at Proposed Hedge Fund Legislation

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Several bills have recently been proposed in the Connecticut Legislature which would impose new regulations on hedge funds operating in Connecticut. Some of these rules are designed to make hedge funds more transparent, with requirements for licensing and reporting. One bill requires them to reveal what is in a side letter. These bills, if passed, would dramatically change the way hedge funds operate in Connecticut.

The three bills would apply stringent regulation to hedge funds in Connecticut, and only in Connecticut, and have the potential to create a potentially hostile environment for hedge funds doing business here; they would certainly increase their cost of compliance.

Richard Slavin, Chair of the Securities practice at Cohen and Wolf, helped write some of the original State analogs to regulation D in the early 1980's. Mr. Slavin is the Connecticut liaison for the ABA's State Securities Law Committee. He is also a former director of the Connecticut Banking Department's Securities and Business Investments Division as well as an ex-staff attorney in the Division of Enforcement at the United States Securities and Exchange Commission in 1981.

Background

After the collapse of the Bayou and Amaranth hedge funds, Attorney General Blumenthal indicated that if Congress did not pass legislation regulating hedge funds, the Connecticut state legislature would. The continuing realization that Connecticut is probably the second or third largest domicile for hedge funds and that the tax revenue and jobs, even at the current diminished levels, are not items that the legislature would like to see moving across the border to New York, halted the move toward regulation. Now that the fallout from Madoff's colossal fraud and the Wall Street Crisis are upon us, every legislator wants to be on board with hedge fund regulation because they are seen as the cause of much of our

problems in the economy. Hedge funds are blamed for the volatility in the markets, hedge fund redemptions, inappropriate pension fund investments and so on.

The current legislation was introduced by some of the same legislators who have introduced hedge fund legislation in prior years. While some of the provisions of these bills are different from those efforts, there is some sense that they may die in committee. In prior years the Attorney General has also submitted a bill which has not progressed beyond the beginning stages. The Banking Department has not taken a position on any of the bills; however, the Banking Commissioner may testify in the coming weeks. There is some sense that Connecticut should wait to see what Congress does. Under existing law the Attorney General can only act to enforce the Connecticut Uniform Securities Act if the Banking Commissioner makes a referral to him for civil action.

Ralph Lambiase, the long-time Director of the Securities and Business Investments Division of the Banking Department takes no position on the existing bills, but in a recent telephone conversation indicated that he does have ideas about potential hedge fund abuses. He advocates a requirement that hedge funds employ third party administrators to account for the funds invested in hedge funds and for fair valuations. No one should be surprised at Mr. Lambiase's position as it basically is a "follow-the-money" kind of solution to the problem. He would like to see the elimination of as much potential for conflict of interest as possible on the part of hedge fund managers in any kind of legislation in connection with hedge funds.

The Connecticut legislative session may last through May and into June. There is certainly enough time to pass legislation, if there is truly a desire to make that happen.

Highlights:

Raised Bill No.953: An Act Concerning Hedge Funds.

This bill would apparently amend the Connecticut Uniform Securities Act and add definitions of "hedge fund", "institutional investor", "investment assets", "investor", "major litigation", "manager" and "material" to the statute. The essential requirements of this bill are the following:

On or after January 1, 2011, no hedge fund shall consist of individual investors who, individually or jointly with a spouse, have less than two million five hundred thousand dollars in investment assets or institutional investors that have less than five million dollars in assets.

2. A hedge fund manager must disclose to each investor or prospective investor in a hedge fund, not later than thirty days before any investment in the fund, any financial interests or other interests the manager may have that conflict with or are likely to impair the manager's duties and responsibilities to

investors.

3. the manager must disclose in writing to each investor in a hedge fund any material change in investment strategy and philosophy of the fund and the departure of any individual employed by such fund who exercises significant control over the investment strategy or operation of the fund, the existence of side letters provided to investors, and any major litigation involving the fund or governmental investigation of the fund.

4. On January 1, 2010 and annually thereafter, the manager shall disclose in writing to each investor the fee schedule to be paid by the hedge fund including but not limited to management fees, brokerage fees, and trading fees and a financial statement indicating the investor's capital balance that has been audited by an independent auditing firm.

5. The Banking commissioner may adopt regulations.

Neither this bill nor the Attorney General's bill, which tracks most of this language, give the Attorney General enforcement powers and the bill seems to continue to vest jurisdiction over hedge funds in the Banking Commissioner, who is the securities regulator in Connecticut.

The hedge fund definition includes any investment company as defined in Section 3 (a) (1) of the Investment Company Act of 1940, located in this state (A) that claims an exemption under 3(c) (1) or Section 3(c) (7) of the Investment Company Act of 1940 whose offering of securities is exempt under the private offering safe harbor criteria in Rule 506 of Regulation D of the Securities Act and that meets any of the criteria established by the Banking commissioner in regulations. A hedge fund is located in Connecticut if it has an office in Connecticut where employees regularly conduct business on behalf of the hedge fund.

If passed, I think the legislature would be taking the position that there is no preemption as this legislation does not impose any regulation of a private offering under Rule 506 but simply regulates the hedge fund which has raised money under Rule 506. given the definition of "hedge fund" under this proposal no fund located in Connecticut could raise money anywhere from individuals who have less than \$2,500,000 in investment assets or from institutional investors who have less than \$5,000,000 in assets.

Clearly this legislation adopts some of the concepts of the proposed Regulation D which have not yet been adopted by the SEC. It's a good question whether the legislation would withstand a preemption challenge under Section 18. It certainly appears to be an issue in this form.

The bill also defines "institutional investor". In Section 36b-21(b) (9) there is an exemption for a sale to an "institutional buyer: which has not really been defined under the Act. Arguably this definition would define an institutional buyer as, among other definitions, as a "corporation or any other legal entity".

Raised Bill 6477 An Act Concerning the Licensing of Hedge Funds and Private Capital Funds.

This bill creates a licensing requirement for a hedge fund or a "private capital fund" and leaves the definitions and procedures for the Banking Commissioner.

Raised Bill No. 6480 An Act Requiring the Disclosure of Financial Information to Prospective Investors in Hedge Funds and Private Capital Funds.

This bill requires any hedge fund or private capital fund domiciled in Connecticut that receives money from pension funds domiciled in Connecticut to disclose to each prospective pension investor in those funds, upon request, financial information including but not limited to, detailed portfolio information relative to the assets and liabilities of those funds.

What's going to happen?

The outcome is uncertain but the popular notion is that Connecticut legislators want to enact some kind of regulation of hedge funds. There is some sense that these kinds of regulatory requirements can protect Connecticut citizens and pension funds from the Madoff schemes, from Amaranth, or Bayou Fund type problems. On the other hand is the continuing realization that Connecticut is probably the second or third largest domicile for hedge funds and that the tax revenue and jobs, even at the current diminished levels, are not items that the legislature would like to see moving across the border to New York.

ATTORNEYS

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