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Connecticut-Based Private Funds Continue to Face Increased Regulation

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Earlier this winter Connecticut lawmakers introduced three pieces of legislation that would increase the regulatory obligations of private funds operating in Connecticut: *An Act Concerning Hedge Funds* (S.B. No. 953), *An Act Concerning the Licensing of Hedge Funds and Private Capital Funds* (H.B. No. 6477), and *An Act Requiring Disclosure of Financial Information to Prospective Investors in Hedge Funds and Private Capital Funds* (H.B. No. 6480). Although the Acts are directed at hedge funds, they appear to apply equally to other private funds, including private equity and venture capital funds. Connecticut's hedge fund industry is sizable; by some estimates Connecticut has the third-largest concentration of hedge fund assets under management in the world, following New York and London.

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Last week *An Act Concerning Hedge Funds* was approved 15-1 by the Connecticut General Assembly's Banks Committee. As a result of the Committee's favorable vote, the Act was filed with the Connecticut Legislative Commissioners' Office and is currently being reviewed by the General Assembly's staff offices. A summary of the Act is provided below. As a practical matter, in order to be enacted this calendar year the Act must be passed prior to the June close of the 2009 General Assembly session.

In welcome news to Connecticut-based private fund managers, neither *An Act Concerning the Licensing of Hedge Funds and Private Capital Funds*[1] nor *An Act Requiring Disclosure of Financial Information to Prospective Investors in Hedge Funds and Private Capital Funds*[2] was voted on by the Banks Committee last week. As a result, under the General Assembly's rules both Acts are no longer under consideration by this year's General Assembly.

Summary of *An Act Concerning Hedge Funds*

An Act Concerning Hedge Funds[3] seeks to regulate private funds, including hedge funds, private equity funds, and venture capital funds, that: (i) have a Connecticut office where employees regularly conduct

business on behalf of the fund; (ii) privately offer securities in reliance on Regulation D under the Securities Act of 1933; and (iii) are not registered as "investment companies" with the Securities and Exchange Commission pursuant to the exceptions set forth in either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940.

The Act permits the Banking Commissioner to establish additional criteria requiring registration in Connecticut.

Funds regulated under the Act would be required to provide enhanced disclosure to prospective and current investors. Disclosure obligations would include:

- reporting, no later than thirty days prior to any investment, conflicts of interest that would impair the manager's ability to carry out its duties and responsibilities to the fund or its investors;
- providing written disclosure of any material change in the fund's investment strategy and philosophy; the departure of certain key persons; the existence of any side letters; and major litigation or governmental investigation involving the fund; and
- on an annual basis commencing January 1, 2010, providing written disclosure regarding fees paid by the fund (e.g., management, brokerage, and trading fees), and a financial statement indicating that the investor's capital account was audited by an independent auditing firm.

In addition, funds regulated under the Act would be prohibited from admitting natural person investors who, individually or jointly with a spouse, have less than $2.5 million in investments.[4] The Act does not address whether current natural person investors would be grandfathered. Connecticut's natural person qualification standard, if enacted, would be higher than the current natural person "accredited investor" standard set forth under Regulation D.[5]

If enacted, the Act would become effective October 1, 2009.

Conclusion

Connecticut lawmakers and Connecticut Attorney General Richard Blumenthal have suggested that federal oversight of private funds is preferable to oversight by Connecticut's regulatory agencies, and we therefore expect that Connecticut lawmakers will be closely tracking the progress of this year's proposed federal legislation aimed at regulating private funds and fund managers, such as the *Hedge Fund Transparency Act* introduced in the United States Senate by Senators Chuck Grassley (R-Iowa) and Carl Levin (D-Mich.) earlier this year.[6] If heightened regulation of private funds is enacted by Congress at the federal level, it is possible that the Act may not be approved by this year's General Assembly.

We will continue to monitor the progress of *An Act Concerning Hedge Funds*, and will update you regarding any significant developments. If you have questions regarding this Client Alert, please contact a member of the Private Equity Fund Group at Morrison & Foerster LLP.

Footnotes

[1] The Act would have required hedge funds and "private capital funds" established or doing business in Connecticut to be licensed by Connecticut's Banking Commissioner.

[2] The Act would have required hedge funds and "private capital funds" domiciled in, or receiving money from pension funds domiciled in, Connecticut to disclose to prospective pension investors upon request financial information relating to the fund in which they are investing.

[3] The text of *An Act Concerning Hedge Funds* is available at:
http://www.cga.ct.gov/2009/TOB/s/pdf/2009SB-00953-R00-SB.pdf

[4] The Act additionally provides that institutional investors must have not less than $5 million in investment assets, but this requirement is not significantly different from the current "accredited investor" standard under Regulation D for institutional investors. We note that the Connecticut natural person qualification standard is similar to the "accredited natural person" standard proposed by the SEC in December 2006.

[5] Regulation D currently provides that a natural person is an "accredited investor" if at the time of investment he/she has individual net worth, or joint net worth with his/her spouse, in excess of $1 million, or has had income in excess of $200,000 in each of the two most recent years, or joint income with his/her spouse in excess of $300,000, and has a reasonable expectation of reaching the same income level in the current year.

[6] Please see our February 2009 Client Alert, "Regulating Private Funds and Their Investment Advisers: A Summary of Recently Proposed Legislation", for additional information.
