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Hedge Fund Law Report
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Trio of Bills Proposed in Connecticut Legislature Would Introduce Substantial State Regulation of Hedge Funds

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By Christopher Faille, *Hedge Fund Law Report*

In the January 2009 Session of the Connecticut General Assembly, Connecticut lawmakers proposed three bills that would increase the state's role in the regulation of private investments funds, including hedge funds, with various types of connections to Connecticut. In particular, lawmakers proposed the following:

- Connecticut Senate Bill No. 953, "An Act Concerning Hedge Funds" (CT Senate Bill), which generally would raise qualifications for investors in private funds that have offices in Connecticut where employees regularly conduct business on behalf of the funds, and expand disclosure requirements applicable to such funds;
- Connecticut House Bill No. 6477, "An Act Concerning the Licensing of Hedge Funds and Private Capital Funds" (CT House Licensing Bill), which generally would require hedge funds established or conducting business in Connecticut to obtain a license from the Connecticut Banking Commissioner; and
- Connecticut House Bill No. 6480, "An Act Requiring the Disclosure of Financial Information to Prospective Investors in Hedge Funds and Private Capital Funds" (CT House Pension Bill), which generally would require hedge funds domiciled in Connecticut and receiving money from Connecticut pension funds to disclose to prospective pension fund investors, upon request, certain financial information.

All three bills have been referred to the Banks Committee of the Connecticut General Assembly. In addition, at a public hearing held by the Banks Committee on February 24, 2009, Connecticut Attorney General Richard Blumenthal proposed an alternative scheme of state hedge fund regulation.

The legislative bills and Attorney General Blumenthal's proposals are especially noteworthy because an estimated 9.5 percent of the assets in hedge funds are managed by managers in Greenwich, Stamford and Westport, Connecticut. Many hedge funds managed by Connecticut-based managers would fall outside of the scope of the bills as currently drafted, at least under a literal reading. This is because many hedge funds are organized in Delaware or a non-US jurisdiction (e.g., the Cayman Islands or the British Virgin Islands), even if their managers are organized in Connecticut or have offices there. For example, the CT Senate Bill applies, by its terms, to a hedge fund "if such fund has an office in Connecticut where employees regularly conduct business on behalf of the hedge fund." Many hedge fund managers – even those based in

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Connecticut – take pains to avoid establishing offices for their funds in Connecticut, for tax and regulatory reasons. Similar linguistic legerdemains could be used to argue that hedge funds organized in Delaware or offshore do not fall within the scope of the Connecticut House bills.

But the intent of all three bills, and of Attorney General Blumenthal's proposal, is clear enough: with respect to hedge funds and other private funds in its jurisdiction, Connecticut wants to raise the financial bar required for natural persons or institutions to be eligible to invest, and wants greater disclosure, especially to pension fund investors. If the proposed bills do not accomplish these goals as currently drafted, Connecticut legislators appear willing to revise the drafting. As Connecticut Senator Duff, co-chair of the Banks Committee, told the Hedge Fund Law Report, the bills are still in draft form, and are subject to revision and amendment.

On a parallel track, bills providing for federal regulation of hedge funds and hedge fund managers have been proposed in the US Senate and House. See "Levin and Grassley Introduce Bill that would Require Hedge and Other Private Funds to Register to Avoid Regulation as Investment Companies," Hedge Fund Law Report, Vol. 2, No. 5 (Feb. 4, 2009); "Representatives Castle and Capuano Propose Bill on Hedge Fund Adviser Registration, and Representative Castle Proposes Bills on Pension Investments in Hedge Funds and Study of the Hedge Fund Industry," Hedge Fund Law Report, Vol. 2, No. 7 (Feb. 19, 2009). The substance of these bills overlaps in important ways with the substance of the Connecticut bills, and if the federal bills (or some of them) become law, they may preempt the Connecticut bills, in whole or in part. John Brunjes, a Partner in the Private Investment Funds Group of Bracewell & Giuliani LLP, and head of the firm's Fund Formation practice, noted in a discussion with the Hedge Fund Law Report that federal regulation of hedge funds could preempt state regulation in the same substantive areas. He also described the efficiency rationale for preemption generally: "If the regulation of funds is left to the states," he said, "the country could end up with something akin to what you see with insurance regulation – a crazy patchwork quilt. That would be hugely inefficient and would likely drive managers to jurisdictions with more manageable regulatory schemes."

The CT Senate Bill – Investor Qualification and Disclosure Requirements

The CT Senate Bill would apply to "hedge funds," which the bill defines to mean any investment company, as defined in Section 3(a)(1) of the Investment Company Act of 1940 (Investment Company Act), located in Connecticut, (1) that claims an exemption under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act; (2) that offers its securities pursuant to the exemption from the public offering rules provided in Rule 506 of Regulation D under the Securities Act of 1933 (Securities Act); and (3) that meets any other criteria as may be established by the Connecticut Banking Commissioner. Accordingly, the bill would apply to entities beyond those typically understood as hedge funds – it would also apply to private equity funds, venture capital funds and other private funds.

The definition of hedge fund in the CT Senate Bill bears certain similarities to definitions in hedge fund regulation bills proposed at the federal level, and also includes some important differences. In terms of similarities, with the exception of item (3) – any criteria established by the Banking Commissioner – the definition of "hedge fund" in the CT Senate Bill largely tracks the definition of "hedge fund" in the Pension Security Act of 2009, which was introduced into the US House of Representatives in January by Rep. Michael Castle (R-Delaware). See "Representatives Castle and Capuano Propose Bill on Hedge Fund Adviser Registration, and Representative Castle Proposes

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Bills on Pension Investments in Hedge Funds and Study of the Hedge Fund Industry," Hedge Fund Law Report, Vol. 2, No. 7 (Feb. 19, 2009).

And in terms of differences, unlike the bill proposed in late January 2009 by US Senators Grassley and Levin, which would only require registration of funds with at least $50 million in assets under management (AUM), the CT Senate Bill does not contain an AUM threshold, and thus would apply, as written, even to small hedge funds. See "Levin and Grassley Introduce Bill that would Require Hedge and Other Private Funds to Register to Avoid Regulation as Investment Companies," Hedge Fund Law Report, Vol. 2, No. 5 (Feb. 4, 2009).

With respect to "hedge funds" as defined in the CT Senate Bill, the bill would require the following:

Investor Qualification

Starting on January 1, 2011, the CT Senate Bill would require individual investors in hedge funds to have, individually or jointly with a spouse, at least $2.5 million in "investment assets," and would require institutional investors in hedge funds to have at least $5 million in "assets." The bill defines "investment assets" to include any security, real estate held for investment purposes, bank deposits, cash and cash equivalents, commodity interests held for investment purposes and other forms of investment assets as may be established by the Banking Commissioner. Notably, the $2.5 million threshold for individuals in the CT Senate Bill matches the threshold included in a rule proposed by the SEC in January 2007, but not adopted, that would have required a natural person to, among other things, own at least $2.5 million in "investments" in order to be an "accredited investor" and thus eligible to purchase securities in Regulation D offerings. See "Accredited Investor Requirements Could Change, Limiting New Fund Formation and Capital Raising Opportunities for Hedge Funds," Hedge Fund Law Report, Vol. 2, No. 4 (Jan. 28, 2009).

As drafted, the bill does not provide an exception or safe harbor for current hedge fund investors who do not meet the increased qualification requirements. Under current Rule 501 under the Securities Act, an individual qualifies as an accredited investor if the individual has either a net worth of at least $1 million or the individual had an income exceeding $200,000, or a joint income with his or her spouse exceeding $300,000, in each of the two most recent years, and a reasonable expectation of reaching the same income level in the current year. Accordingly, there may be investors in covered hedge funds who meet the current federal accreditation standards, but not the state accreditation standards included in the bill. Perhaps such investors would be eligible to remain in covered funds but not to increase their positions in the funds? Presumably a revised version of the bill would address this point.

Disclosure of Conflicts

The CT Senate Bill would require managers of covered hedge funds to disclose to investors and prospective investors, no later than 30 days prior to any investment in a hedge fund, any actual or potential conflicts of interest, financial or non-financial, that could impair the manager's duties and responsibilities to the fund or its investors. This provision appears to be intended to create a month-long period during which investors can assess the advisability of going forward with an investment, in light of any conflicts disclosed by the manager.

Strategy, Side Letters and Litigation

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The CT Senate Bill would require managers of covered hedge funds to disclose to investors, in writing: (1) any material change in the "investment strategy and philosophy" of the fund and the departure of any key employee of the fund, (2) the existence of any side letters provided to investors in the fund and (3) any major litigation involving the fund or governmental investigation of the fund. The bill does not define or otherwise provide guidance as to what constitutes a "material" change in a fund's strategy, or what qualifies as "major" litigation. Similarly, the bill does not call for disclosure of any litigation or governmental investigation of the management entity. Notably, the bill calls only for disclosure of the existence of side letters, but not for disclosure of the content of such side letters.

Financial Disclosures

Beginning on January 1, 2010, and annually thereafter, the CT Senate Bill would also require managers of covered funds to disclose in writing to each investor: (1) the fee schedule to be paid by the fund including management fees, brokerage fees and trading fees and (2) an audited financial statement indicating the investor's capital balance. (The bill is silent on the period that the audited financial statement would need to cover.)

CT House Licensing Bill

The CT House Licensing Bill would require each "hedge fund" or "private capital fund" established or conducting business in Connecticut to obtain, by submitting an application and a $500 fee, a license from the Connecticut Banking Commissioner. Each fund would be required to renew its license annually upon payment of a $500 fee. Unlike the CT Senate Bill, which defines the term "hedge fund" by reference to federal statutes, the CT House Licensing Bill does not define the terms "hedge fund" or "private capital fund," nor does it provide criteria that the Banking Commissioner or other authority would be required or permitted to consider in granting or rejecting an application for a banking license. Also, the CT House Licensing Bill does not mandate licensing of management entities.

CT House Pension Bill

The CT House Pension Bill would require any "hedge fund" or "private capital fund" domiciled in Connecticut and receiving money from pension funds domiciled in Connecticut to disclose to each prospective pension fund investor in the fund, upon request, financial information including, but not limited to, detailed portfolio information relating to the assets and liabilities of such funds. Like the CT House Licensing Bill, the CT House Pension Bill does not define "hedge fund" or "private capital fund," so presumably both phrases can include funds well beyond the scope of funds typically thought of as hedge funds. Similarly, as drafted, the CT House Pension Bill contains no limitation on the categories of financial information that a prospective pension fund investor could request, and that a fund would be required to provide.

Equity would seem to require some limitations on the categories of financial data that prospective pension fund investors can request and that hedge funds would be required to provide. Otherwise, prospective pension fund investors could demand, even prior to making an investment in a fund, precisely the sort of privileged transparency that the President's Working Group's Asset Managers' Committee and regulators have been trying to curtail in statements and recommendations against side letters. See "President's Working Group Releases Final Best

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Practices Reports for Hedge Fund Managers and Investors," Hedge Fund Law Report, Vol. 2, No. 5 (Feb. 4, 2009). In any case, even if subsequent drafts of the bill scale back on this provision, hedge fund managers would be well advised to disclose financial information to prospective pension fund investors only under the terms of a confidentiality agreement; nothing in the bill prohibits such agreements.

Industry Reactions to the CT Senate Bill

Side Letters – A "Commercial Reality"

Regulators and supervisory entities have for some time expressed concern that side letters privilege certain investors over others. At a 2006 congressional hearing, Susan Wyderko, then Acting Director of the SEC's Division of Investment Management, said that some side letter terms "may involve material conflicts of interest that can harm the interests of other investors. Chief among these types of side letter terms are those that give certain investors liquidity preferences or provide them with more access to portfolio information." See "Disclosure of Side Letter Terms: Are Some Investors More Equal Than Others?," Hedge Fund Law Report, Vo. 1, No. 5 (Mar. 31, 2008). More recently, in its Final Best Practices Report, the Asset Managers' Committee of the President's Working Group on Financial Markets suggested that hedge fund managers disclose to investors the material terms of any side letters that may adversely impact the interests of other investors. See "President's Working Group Releases Final Best Practices Reports for Hedge Fund Managers and Investors," Hedge Fund Law Report, Vol. 2, No. 5 (Feb. 4, 2009). From time to time, the SEC and the Financial Services Authority in the UK, and their staff members, have also made statements suggesting that the regulators would not look favorably upon side letter arrangements.

Incidentally, many hedge fund managers do not embrace side letters either. Those who enter into side letter agreements generally do so reluctantly, and with a specific purpose, for example, bringing in a big investor or accommodating the needs of a special investor. As Brunjes commented to the Hedge Fund Law Report, "side letters are primarily used for the marquee investor, or an investor proposing a substantial investment in the fund, or for investors who have special circumstances, such as public pension funds. These are important types of investors for a growing or established fund to add to their roster. But the process of keeping track of the side letters creates an administrative burden for the managers, so they prefer not to go down that road unless they have to."

In many cases, small investors find themselves in the same boat as managers: they do not like side letters, but they see them as what Bradley Kulman, a Partner with Stroock & Stroock & Lavan LLP, called a "commercial reality." As Kulman told the Hedge Fund Law Report: "Small investors in hedge funds are those, for example, who have put in 'just' a million or two. They understand commercial reality. They understand that they aren't going to get the same deal on some points as is the investor who puts in $100 million. Such push-back as the 'small' investors express is the normal give-and-take of commercial relationships."

The CT Senate Bill appears, in a sense, to reflect the industry's tortured relationship with side letters. It strikes a decidedly ambiguous posture: it does not prohibit side letters outright, nor does it require the disclosure of all of the terms of a fund's side letters, or even the material terms. Rather, it calls only for disclosure to investors in writing of the existence of any side letters. Such disclosure would give all fund investors notice of the existence of side letters, and presumably can form the basis for questions from investors to the manager about the content of those side letters. But it would not, for example, enable a smaller investor, or a group of them,
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to say to the manager: big investor X is getting monthly liquidity while we're getting quarterly liquidity. That's not fair, and we're going to walk as a group unless you give all investors equal liquidity. In short, the CT Senate Bill gets the ball rolling in terms of leveling the side letter playing field, but it leaves a lot of leveling to be done.

30 Days Advanced Notice of Conflicts

Kulman, of Stroock, noted that while the provision in the CT Senate Bill requiring disclosure of conflicts to investors and prospective investors no later than 30 days prior to any investment has not received substantial attention yet, it could, if adopted as law, have a profound effect on the pace of hedge fund marketing. It would, in a word, cool and slow down a process that most in-house hedge fund marketing departments and third party marketers would prefer to move along at as brisk a pace as possible. "There hasn't been a lot of attention paid to this provision yet," Kulman said, "but it would really change how a lot of hedge funds do their marketing. Investors don't typically take out their check book immediately upon looking at the offering documents, but thirty days is a long time."

Disclosure of "Style Drift"

Kulman also questioned the relevance and practicability of the requirement in the CT Senate Bill that hedge fund managers disclose to investors in writing any material change in the investment strategy of their funds. "That sounds like an enforcement nightmare and it also sounds like something of dubious relevance to many hedge funds," he said. "Of course, there are some hedge funds with a very specific niche, but there are others who don't define their philosophy in a narrow way, or who define it as global macro, which means that the fund has the ability to take positions in any type of security or market."

Yet while the governing documents of some funds vest broad investment discretion in the manager, other funds promise to follow a specific mandate, and many investors invest with the understanding that the manager will stick to that mandate. As Brunjes explained, "an investor that chooses a particular manager because it needs that particular investment strategy in its portfolio does not want its capital deployed in a substantially different style. A good manager will inform its investors when it is making investments that move away from the core investment objective, to the extent allowed in the offering memoranda. But the burden of disclosure right now is on the manager to come forward with that information. At the end of the day, it is about trust."

For investors in more narrowly-mandated funds, therefore, required disclosure of style drift can be helpful in identifying the appropriate time for a redemption, or at least a conversation with the manager – assuming, of course, that such disclosure is practicable and the requirement is enforceable.

Industry Reactions to the CT House Pension Bill

According to Brunjes, the (often unknowing or involuntary) exposure of retail investors to hedge funds via their investments in pension funds is the gravamen of much of the ongoing debate about regulating hedge funds and managers. "Losses are losses of people's retirement savings, not of free investable cash," he noted. "So the rationale [of the CT House Pension Bill] is that there should be different rules for hedge funds and private equity funds that receive pension investments." Nonetheless, Brunjes wondered whether a more broadly applicable transparency
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mandate could not serve the political imperative that the CT House Pension Bill aims to achieve, while also providing for more horizontal equity among investors. "As pension investment decisions are made by highly skilled professional investors," he said, "a rational set of rules providing an appropriate level of transparency for all investors would presumably serve the needs of all investors."

Blumenthal Proposal

In testimony before the Banks Committee on February 24, 2009, after noting that hedge funds "currently operate without any meaningful legislation or oversight by federal or state governments," and that "[h]edge funds inhabit a regulatory black hole," Connecticut Attorney General Richard Blumenthal proposed his own hedge fund state regulatory scheme as an alternative to the three bills described above. The Blumenthal proposal defines "hedge funds" using the same three criteria as the CT Senate Bill, but adds to those criteria a requirement that the fund offers to or solicits investors in Connecticut or has one or more investors who reside in or have a principal place of business in Connecticut. The Blumenthal proposal would require hedge funds, as defined in the proposal to, among other things:

- Comply with SEC rules for minimum asset requirements for investors in unregulated hedge funds;
- Disclose in the offering statement to prospective investors any conflicts of interest on the part of the fund manager, the fee schedule of management and brokerage fees and any side letter agreements regarding preferential treatment for certain investors;
- Disclose to current investors on a quarterly basis any conflicts of interest or new preferential treatment side letters within 30 days of the existence of such conflict or letter;
- Disclose to current investors on a quarterly basis the current investments of such hedge fund and a general description of the fund's investment strategy;
- Disclose to current investors within seven days of knowledge of the existence of major litigation against the fund, a governmental investigation or major change in investment strategy, provided the hedge fund has not entered into a confidentiality agreement with the government agency conducting the investigation;
- Annually disclose to current investors, within 60 days of the end of the fiscal year, the fee schedule, the amount of fees, personnel expenses and consultant costs paid in the previous year and an independently audited financial statement; and
- Register with the State of Connecticut unless the hedge fund registers with the SEC.

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