

Bill Requiring Hedge Fund Managers to Disclose “Material Conflicts of Interest” Passes Connecticut State Senate

By Christopher Faille

On May 26, 2009, Connecticut’s Senate passed a bill that, if passed by the House and signed into law by the Governor, would require investment advisers to hedge funds and other private investment funds, whether or not registered with the Securities and Exchange Commission (SEC), to disclose “material conflicts of interest.”

The heart of Connecticut Senate Bill No. 953, “An Act Concerning Hedge Funds,” is Subsection 1(b), which provides: “Any investment adviser to a private investment fund, regardless of whether such investment adviser is registered with the United States Securities and Exchange Commission, shall comply with the disclosure requirements of Rule 204-3 under the Investment Advisers Act of 1940 . . . provided nothing in this subsection shall require the disclosure of any information other than material conflicts of interest of the investment adviser.”

Legislative History

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 the bill as adopted by the Senate is a considerable change from earlier versions of this bill. See “Trio of Bills Proposed in Connecticut Legislature Would Introduce Substantial State Regulation of Hedge Funds,” The Hedge Fund Law Report, Vol. 2, No. 9 (Mar. 4, 2009). The bill began life with the goal of raising qualifications for investors in private funds that have offices

in Connecticut where employees regularly conduct business on behalf of the funds, as well as requiring specific disclosures with respect to fund management.

“This started out as a fund manager registration bill,” Brunjes said. “Presumably the Senators realized they were unfairly burdening Connecticut’s in-state managers. So it has developed into something that looks like an investor-protection scheme. One perverse consequence is that these disclosure requirements may dissuade legitimate out-of-state managers from doing business in Connecticut, depriving this state’s investors of credible alternative investment opportunities.” That bill would impose its disclosure requirements on two sets of investment advisers to private investment funds – those based in Connecticut, as well as out-of-state advisers who solicit investors in Connecticut.

Likelihood of Passage

Although the Senate voted 24 to 12 in favor of the bill, prospects for passage remain uncertain. Peter J. Bilfield, a Partner at Shipman & Goodwin LLP, explained to The Hedge Fund Law Report: “The current legislative session ends on June 3, leaving little time for the House to act. Even if the session ends without action by the House, there is a special session this summer, and it is possible, although unlikely, that the issue of hedge fund regulation (in a more robust form than currently contemplated) could be included in its business.”

Connecticut's Governor, M. Jodi Rell, has not yet indicated whether she would sign the bill in its current form. Under the state's Constitution, the Governor has five days to sign or veto a bill if it is presented to her while the legislature is still in session. Should it be passed near the end of session, and presented to the Governor thereafter, she has 15 days to act on it.

Waiting for the Feds

Bills providing for federal regulation of hedge funds and hedge fund managers have been proposed in both the U.S. House and Senate. See, "Levin and Grassley Introduce Bill that would Require Hedge and Other Private Funds to Register to Avoid Regulation as Investment Companies," *The 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," *The Hedge Fund Law Report*, Vol. 2, No. 7 (Feb. 19, 2009); "Consensus in Financial Services Committee Hearing on Castle and Capuano Bill (Hedge Fund Advisor Registration Act of 2009) Suggests Support for Comprehensive Overhaul, Increased Transparency and Exemption from Registration for Smaller Advisers," *The Hedge Fund Law Report*, Vol. 2, No. 19 (May 13, 2009).

Accordingly, the Connecticut bill allows for the possibility of preemptive federal action. By its terms, it will go into effect on January 1, 2010, unless on or by December 31, 2009, the U.S. Congress has amended the Investment Advisers Act in a manner that regulates advisers to private investment funds, or the SEC has adopted regulations having a similar effect.

Banking Commissioner's Role

If the bill becomes law, the Connecticut Banking Commissioner may, but does not have to, adopt regulations to implement it. The language of Section 2 of the bill is permissive, not mandatory: "The Banking Commissioner may adopt regulations . . . to implement the provisions of section 1 of this act." However, the bill also provides that no investment adviser will be required to comply with the disclosure requirements in the bill until the Banking Commissioner has adopted implementing regulations.

Earlier drafts of the bill would have required managers of subject funds to disclose to investors in writing: (1) any material change in the investment strategy and philosophy of the fund or the departure of any key employee; (2) the existence of any side letters provided to investors in the fund; and (3) any major litigation involving the fund or governmental investigation thereof.

With respect to those provisions, Brunjes said: "There is nothing specific regarding those kinds of disclosures in this bill in the form in which the Senate has now passed it. If enacted, however, the state's Banking Commissioner has the discretion to develop implementing regulations, but those areas would only be addressed if the Commissioner decides they bear on material conflicts of interest."

Rule 204-3

The gist of the bill is to require investment advisers to comply with the disclosure requirements of Investment Advisers Act Rule 204-3. That rule requires registered investment advisers to furnish each advisory client or prospective advisory client with a disclosure statement, which may be either a copy of

Part II of the adviser's Form ADV or a written document containing at least the information that would be required by Part II of Form ADV, not less than 48 hours prior to entering into any investment advisory contract with such client or prospective client or at the time of entering into such a contract, if the client has the right to terminate the contract without penalty within five business days thereafter.

Rule 204-3 details requirements as to the delivery of this information, the making of annual offers to deliver the information and the omission of inapplicable information.

"One basic problem" with understanding the implications of the proposed bill, Brunjes said, is "that the phrase 'material conflicts of interest' for this purpose is not defined in Rule 204-3 or anywhere else in the federal Advisers Act or regulations." Yet the proposed bill, which incorporates the delivery requirements of 204-3, expressly incorporates its content requirements only to the extent they involve material conflicts of interest.

Bilfield, of Shipman & Goodwin, expressed a similar concern with the utility and clarity of the bill in its current form: "I'm not really sure how useful the new legislation in its current form would be. The Senate bill focuses on the

disclosure of material conflicts of interest, but to the extent there are conflicts of interest, private investment funds generally disclose such conflicts within a private placement memorandum to comply with the anti-fraud rules under federal securities laws. Additionally, any material conflicts of interest which develop after the circulation of the private placement memorandum to investors should be disclosed by the investment adviser to fund investors in a supplement."

Sophisticated Parties

Hal Scott, Director of the Program on International Financial Systems at Harvard Law School, and an independent director of Lazard Ltd., told The Hedge Fund Law Report that he thinks this type of state action does not assist in the task of reforming the national and international systems of financial regulation.

Scott said, of the Connecticut Senate's decision: "I think these matters are federal and indeed international and I don't see why states should be regulating hedge funds." He emphasized that there is no "consumer protection" angle for hedge funds, "because the investors are sophisticated parties – the regulatory concern is with systemic risk, which makes a unitary approach to regulation necessary."