



Senate

General Assembly

File No. 84

January Session, 2007

Senate Bill No. 1171

Senate, March 20, 2007

The Committee on Banks reported through SEN. DUFF of the 25th Dist., Chairperson of the Committee on the part of the Senate, that the bill ought to pass.

AN ACT CONCERNING HEDGE FUNDS.

Be it enacted by the Senate and House of Representatives in General Assembly convened:

1 Section 1. (NEW) (*Effective October 1, 2007*) (a) As used in this
2 section:

3 (1) "Hedge fund" means any investment company, as defined in
4 Section 3(a)(1) of the Investment Company Act of 1940, located in this
5 state (A) that claims an exemption under Section 3(c)(1) or Section
6 3(c)(7) of the Investment Company Act of 1940; (B) whose offering of
7 securities is exempt under the private offering safe harbor criteria in
8 Rule 506 of Regulation D of the Securities Act; and (C) that meets any
9 other criteria as may be established by the Banking Commissioner in
10 regulations adopted under subsection (f) of this section. A hedge fund
11 is located in this state if such fund has an office in Connecticut where
12 employees regularly conduct business on behalf of the hedge fund;

13 (2) "Institutional investor" means an investor other than an
14 individual investor including, but not limited to, a bank, savings and

15 loan association, registered broker, dealer, investment company,
16 licensed small business investment company, corporation or any other
17 legal entity;

18 (3) "Investment assets" includes any security, real estate held for
19 investment purposes, bank deposits, cash and cash equivalents,
20 commodity interests held for investment purposes and such other
21 forms of investment assets as may be established by the Banking
22 Commissioner in regulations adopted under subsection (f) of this
23 section;

24 (4) "Investor" means any holder of record of a class of equity
25 security in a hedge fund;

26 (5) "Major litigation" means any legal proceeding in which the
27 hedge fund is a party which if decided adversely against the hedge
28 fund would require such fund to make material future expenditures or
29 have a material adverse impact on the hedge fund's financial position;

30 (6) "Manager" means an individual located in this state who has
31 direct and personal responsibility for the operation and management
32 of a hedge fund; and

33 (7) "Material" means, with respect to future expenditures or adverse
34 impact on the hedge fund's financial position, more than one per cent
35 of the assets of the hedge fund.

36 (b) On or after January 1, 2009, no hedge fund shall consist of
37 individual investors who, individually or jointly with a spouse, have
38 less than two million five hundred thousand dollars in investment
39 assets or institutional investors that have less than five million dollars
40 in assets.

41 (c) The manager shall disclose to each investor or prospective
42 investor in a hedge fund, not later than thirty days before any
43 investment in the hedge fund, any financial or other interests the
44 manager may have that conflict with or are likely to impair, the
45 manager's duties and responsibilities to the fund or its investors.

46 (d) The manager shall disclose, in writing, to each investor in a
 47 hedge fund (1) any material change in the investment strategy and
 48 philosophy of the fund and the departure of any individual employed
 49 by such fund who exercises significant control over the investment
 50 strategy or operation of the fund, (2) the existence of any side letters
 51 provided to investors in the fund, and (3) any major litigation
 52 involving the fund or governmental investigation of the fund.

53 (e) On January 1, 2008, and annually thereafter, the manager shall
 54 disclose, in writing, to each investor in a hedge fund (1) the fee
 55 schedule to be paid by the hedge fund including, but not limited to,
 56 management fees, brokerage fees and trading fees, and (2) a financial
 57 statement indicating the investor's capital balance that has been
 58 audited by an independent auditing firm.

59 (f) The Banking Commissioner may adopt regulations, in
 60 accordance with chapter 54 of the general statutes, to implement the
 61 provisions of this section.

This act shall take effect as follows and shall amend the following sections:		
Section 1	<i>October 1, 2007</i>	New section

BA *Joint Favorable*

The following fiscal impact statement and bill analysis are prepared for the benefit of members of the General Assembly, solely for the purpose of information, summarization, and explanation, and do not represent the intent of the General Assembly or either chamber thereof for any purpose:

OFA Fiscal Note

State Impact: None

Municipal Impact: None

Explanation

The bill requires the Department of Banking to establish regulations for all hedge funds in Connecticut. It is anticipated that there will be additional workload for the Department of Banking, but no additional resources are required.

The Out Years

State Impact: None

Municipal Impact: None

OLR Bill Analysis**SB 1171*****AN ACT CONCERNING HEDGE FUNDS*****SUMMARY:**

This bill subjects hedge funds to several restrictions and requirements. It defines a hedge fund as an investment company that claims certain exemptions under federal law and regulations and meets any other criteria set out in regulations issued by the banking commissioner. It requires hedge fund investors to meet an asset threshold set by the bill. It requires hedge fund managers to make a number of disclosures, including conflicts of interests, major changes or events that affect the fund, and certain financial information. The bill defines a number of other terms and allows the banking commissioner to adopt regulations to implement its requirements.

EFFECTIVE DATE: October 1, 2007

DEFINITION OF “HEDGE FUNDS”***Location***

The bill defines a hedge fund as an investment company that (1) is located in this state and (2) meets any criteria established by the banking commissioner in regulations enacted under the bill and the two requirements relating to federal securities laws. According to the bill, a hedge fund is considered to be located in this state if it has an office here where employees regularly conduct business on the fund’s behalf. Therefore, the bill appears to be limited to hedge funds located in the state.

Investment Company Registration Exemptions

Under federal law, an issue whose securities are owned by a limited

number of people and which does not plan to make a public offering is exempt from the requirement to register as an investment company. Issuers are exempt from registering if they do not make public offerings and their securities are sold to certain sophisticated investors. In order to be considered a hedge fund under the bill, the investment company must claim one of these exemptions. In addition, the investment company's securities offering must be exempt from registration under the private offering safe harbor criteria in federal regulations (see BACKGROUND).

ASSET REQUIREMENTS

Beginning January 1, 2009, the bill prohibits hedge funds from having investors who fail to meet certain asset requirements. Under the bill, individual investors must have at least \$2.5 million in investment assets individually or jointly with a spouse. The bill defines investment assets as any security, real estate held for investment purposes, bank deposits, cash and cash equivalents, commodity interests held for investment purposes, and others established by the banking commissioner in regulations.

Institutional investors, which are any investor other than an individual, must have at least \$5 million in assets.

DISCLOSURES

The bill requires hedge fund managers to make certain disclosures to investors. It defines a manager as any person located in the state with direct and personal responsibility for the operation and management of a hedge fund. It defines an investor as any record holder of a class of equity security in a hedge fund.

First, a hedge fund manager must disclose any of his interests that might conflict with, or would likely impair, his duties and responsibilities to the fund or its investors. This disclosure must be made to investors or prospective investors at least 30 days before they invest in the fund. The bill does not specify how the disclosure must be made.

Second, managers must disclose in writing to each investor (1) any material change in the fund's investment strategy and philosophy and the departure of any fund employee who had significant control over the fund's investment strategy or operation; (2) the existence any side-letters; and (3) any governmental investigation of the fund or legal proceeding in which the fund is a party that would require the fund to make future expenditures of, or adversely impact its financial position by, more than 1% of its assets if it loses. It appears that these things must be disclosed when they occur but the bill does not set a specific time-frame for the disclosures.

Finally, annually, beginning January 1, 2008, the bill requires hedge fund managers to disclose to investors, in writing, (1) the fee schedule to be paid by the hedge fund, including management, brokerage, and trading fees and (2) an independently audited financial statement indicating the investor's capital balance.

BACKGROUND

Investment Company Registration Exemptions

Under the federal Investment Company Act, an issuer (1) whose outstanding securities are beneficially owned by 100 or fewer persons and (2) who does not plan to make public offerings is exempt from registering as an investment company.

There is also a "sophisticated investor" exemption from Investment Company Act registration requirements. Issuers are exempt from registering under the act if (1) their outstanding securities are owned by "qualified purchasers" and (2) they do not make a public offering of securities. A qualified purchaser is defined as an individual who owns \$5 million worth of investments and certain entities that own \$25 million worth of investments.

Offering Registration Exemption and the Regulation D "Safe Harbor"

Since hedge fund interests are considered securities under the Securities Act of 1933, they would ordinarily be subject to Securities

and Exchange Commission registration requirements. However, the 1993 Act provides an exception to the registration requirements if the interests are not sold in a “public offering.” Under federal regulations, offers and sales of securities by an issuer that satisfy certain conditions are deemed to be transactions not involving any public offering (and therefore, exempt from registration requirements.)

To meet the commonly used “safe harbor” in Regulation D, hedge funds may sell their interests to an unlimited number of “accredited investors.” This term includes (1) a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds \$1 million at the time of the purchase, as distinguished from the bill’s requirement of \$2.5 million in investment assets; (2) a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; (3) institutional investors (corporations and other corporate entities must have \$ 5 million in assets), and (4) an officer of the company selling the securities. Regulation D also allows an issuer to sell its interests to a limited number of non-accredited investors up to (35), if they have sufficient financial knowledge.

COMMITTEE ACTION

Banks Committee

Joint Favorable

Yea 13 Nay 5 (03/06/2007)