C A D W A L A D E R

Cadwalader, Wickersham & Taft LLP
New York London Charlotte Washington Beijing

One World Financial Center, New York, NY 10281
Tel 212 504 6000 Fax 212 504 6666
www.cadwalader.com

Clients&FriendsMemo

The Hedge Fund Transparency Act and Its Unintended Consequences for Cat Bonds

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On January 29, 2009, Senators Carl Levin, D-Michigan, and Charles Grassley, R-Iowa, introduced the Hedge Fund Transparency Act ("HFTA") for passage in the Senate. The HFTA is intended to require hedge funds to register with the Securities and Exchange Commission ("SEC") and thereby subject them to regulation by that body. As currently drafted, however, the HFTA proposes amendments to the Investment Company Act of 1940, as amended (the "1940 Act"), which would require that *any* private investment fund with $50 million or more under management to register with the SEC and meet certain disclosure obligations. Catastrophe or "cat" bond transactions are issued by a special purpose entity which would come within the revised definition of investment companies proposed under the HFTA. Thus far, introductory remarks on the measure have been made by the sponsors and the HFTA has been read twice and referred to the Committee on Banking, Housing and Urban Affairs. If enacted, the regulatory obligations of private investment funds with $50 million or more under management, including cat bond issuers, would increase substantially.

Framework and Disclosure Obligations

Currently private investment funds may avoid being defined as an "investment company" for the purposes of the 1940 Act by complying with the exceptions to the definition set forth in sections 3(c)1 (for funds with fewer than 100 beneficial owners) or 3(c)7 (for funds comprised solely of "qualified purchasers"). Private investment funds relying on these exceptions fall outside the definition of "investment company" under the 1940 Act allowing them to avoid most 1940 Act registration and filing requirements applicable to investment companies. The proposed HFTA strikes sections 3(c)(1) and 3(c)(7) as exclusions from the definition of "investment company," and thus, funds currently relying on such sections would be considered an "investment company" and potentially be subject to the requirements of the 1940 Act.

Sections 3(c)(1) and 3(c)(7) would be replaced with sections 6(a)(6) and 6(a)(7), which, are exemptions to full registration and filing requirements under the 1940 Act similar to sections 3(c)(1) and 3(c)(7). Under sections 6(a)(6) and 6(a)(7), entities with less than $50 million under

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management that (i) have no more than 100 beneficial owners and do not publicly offer their securities or (ii) sell their securities exclusively to “qualified purchasers” and do no publicly offer their securities would be exempt in almost all respects from the requirements of the 1940 Act. Private investment funds with assets under management of $50 million or more (“Large Investment Companies”), however, would be subject to subsection (g), “Limitation on Exemptions for Large Investment Companies,” which, would require private investment funds to register with the SEC under a more limited registration regime and comply with several disclosure requirements some of which may not be possible to comply with for Rule 144A distributions. Failure to comply would require Large Investment Companies to fulfill the full range of applicable registration and disclosure requirements under the 1940 Act.

For Large Investment Companies to qualify for registration and disclosure exemptions under the 1940 Act, the HFTA would require them to perform the following:

1. Register with the SEC.
2. Maintain any books and records that the SEC may require.
3. Cooperate with any request by the SEC for information or examination.
4. File with the SEC electronically an information form at least once annually. Such form would be made available to the public in a searchable format and must include:
    a. The name and current address of each individual who is a beneficial owner of the fund.
    b. The name and current address of any company with an ownership interest in the fund.
    c. The name and current address of the fund’s primary accountant and primary broker.
    d. An explanation of the ownership structure.
    e. Information concerning any affiliation with another financial institution.
    f. A statement of any minimum investment commitment required of a limited partner, member, or investor.
    g. The total number of limited partners, members, or other investors.
    h. The current value of the assets of the fund and the assets under management by the fund.

Anti-Money Laundering Obligations

With the stated purpose of safeguarding against the financing of terrorist organizations and money laundering, an investment company that relies on the exemptions of sections 6(a)(6) and 6(a)(7) of the 1940 Act must establish an anti-money laundering program and report suspicious transactions. If enacted, the HFTA would require within 180 days of enactment the Secretary of the Treasury, in consultation with the SEC and the Commodity Futures Trading Commission, to establish by rule policies, procedures and controls necessary to carry out the anti-money laundering obligations of

investment companies. Minimum requirements for the anti-money laundering program set forth in the HFTA include the use of risk-based due diligence policies, procedures and controls reasonably designed to ascertain and evaluate the identity of foreign persons or entities supplying money to be invested in the investment company.

A Law of Unintended Consequences

Currently section 3(c)(7) enables cat bond issuers to escape the burden of SEC registration and public disclosure required of investment companies under the 1940 Act. While ostensibly targeted at fostering transparency with respect to hedge funds, the HFTA makes no attempt to define hedge funds or limit the effect enactment of the law would have on the many other kinds of entities that rely on the 3(c)(1) and 3(c)(7) exclusions from the definition of "investment company." It can be expected that, if the HFTA does not die in committee, it will be commented on by members of the Committee on Banking, Housing and Urban Affairs as well as the SEC. It is likely, however, that the focus of these bodies will be hedge funds, CDOs and the like, and not the variety of other entities which rely on sections 3(c)(1) and 3(c)(7) that will be affected by the sweeping changes proposed by the HFTA.

If the HFTA is enacted, consideration must be given to complying with its new regulatory regime. Alternatively, it may be worthwhile to contemplate other possibilities for cat bond issuers to be excluded as investment companies under the 1940 Act, possibly by investing proceeds in a manner so that the issuer will not fall within the investment company definition. Sponsors of cat bond transactions and industry professionals should continue to monitor the HFTA legislation and similar proposed reforms which may place new or different burdens on cat bond transactions.

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For further details, please contact:

Malcolm P. Wattman   +1 212 504 6222   malcolm.wattman@cwt.com