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Legislation Proposed by U.S. Treasury Would Require Private Fund Advisers to Register with the SEC

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The U.S. Department of the Treasury (Treasury) recently proposed amendments to the Investment Advisers Act of 1940, as amended (Advisers Act) that would effectively require most investment advisers to private pools of investment capital with minimum U.S. contact to register with the Securities and Exchange Commission (SEC).[1] If enacted, the proposed legislation would have far-reaching implications for advisers of hedge funds, venture capital funds, private equity funds, and other U.S. and non-U.S. domiciled private pools of investment capital. It also would appear to eliminate the "small adviser exception" for advisers who have fewer than 15 clients and do not hold themselves out to the public as investment advisers.

Background

On July 15, the Treasury announced proposed legislation known as the Private Fund Investment Advisers Registration Act of 2009 (Proposed Act). The Proposed Act is the latest initiative in the current administration's attempt to monitor systemic risk in the global financial market and to safeguard the investing public from fraud and abuse. Also on July 15, Andrew Donohue, Director of the Division of Investment Management of the SEC, testified before the U.S. Senate Committee on Banking, Housing, and Urban Affairs about the impact private funds have on the financial system, the lack of information available to regulators about private funds, and the need for increased regulation and oversight of private funds.[2]

Proposed Changes

Definition of "Private Fund" and Registration Requirement. The Proposed Act sets forth a broad definition of "private fund." Under the Proposed Act, investment advisers of private funds must register with the SEC. A "private fund" is defined as any investment fund that (i) would be an investment company under the Investment Company Act of 1940, as amended (Investment Company Act) but for the exclusion from the definition of investment company under Section 3(c)(1) or 3(c)(7) of the Investment Company Act, ***and*** (ii) meets one of the following requirements: (a) is organized in or created under the laws of, the United States or a State, ***or*** (b) has 10% or more of its outstanding securities owned by U.S. persons (although it is unclear how this would be calculated in a limited partnership context).

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[1] *See* Press Release, U.S. Treasury, Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward: Legislation for the Registration of Hedge Funds Delivered to Capitol Hill (July 15, 2009), *available at* http://www.treas.gov/press/releases/tg214.htm. The full text of the Private Fund Investment Advisers Registration Act of 2009 can be found online, *available at* http://www.treas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf.

[2] Andrew Donohue, Director of the Division of Investment Management of the Securities and Exchange Commission before the Sub-committee on Securities, Insurance and Investment of the U.S. Senate Committee of Banking, Housing and Urban Affairs, Testimony Concerning Regulating Hedge Funds and Other Private Investment Pools (July 15, 2009), *available at* http://www.sec.gov/news/testimony/2009/ts071509ajd.htm. Mr. Donohue's testimony was in regard to the Private Fund Transparency Act of 2009, introduced by Senator Jack Reed of Rhode Island. S. 1276, 111th Congress (June 16, 2009). The Private Fund Transparency Act of 2009 is substantially similar to the Proposed Act, but not as comprehensive.

This broad definition of "private fund" would effectively require the adviser to any hedge fund, venture capital fund, or private equity fund organized in the U.S. or with 10% or more of its outstanding securities owned by U.S. persons to register with the SEC. The breadth of the definition of "private fund" also could encompass other types of private pools of investment capital, including certain real estate funds and collateralized debt obligations and collateralized mortgage obligations.

Definition of "Foreign Private Adviser." The Proposed Act also sets forth a narrow definition of "foreign private adviser." Advisers who satisfy the definition of "foreign private adviser" would not have to register under the Advisers Act. In order to be deemed a foreign private adviser an investment adviser must be an investment adviser that:

- Has no place of business in the U.S.
- Has served fewer than 15 U.S. clients within the last 12 months
- Has less than $25 million in assets from U.S. clients under management within the last 12 months
- Does not hold itself out as investment adviser to the U.S. investing public
- Does not act as investment adviser to a registered investment company or a business development company under the Investment Company Act

Increased Regulatory Oversight and Disclosure. If enacted, the Proposed Act would substantially increase the reporting requirements and regulatory oversight of the private fund advisers who would be required to register. Each adviser to a private fund would be required to file records and reports with the SEC, which at a minimum would include information as to each fund's:

- Amount of assets under management
- Use of leverage (including off-balance-sheet leverage, such as swaps)
- Counterparty credit risk exposures
- Trading and investment positions
- Trading practices

The Proposed Act also permits the SEC to require additional records and reports to be filed as the SEC may determine to be necessary or appropriate for the assessment of systemic risk by the Board of Governors of the Federal Reserve System and the (recently proposed) Financial Services Oversight Council (Council).[3]

Each adviser registered under the Proposed Act would be subject to recordkeeping requirements for the above-listed records and reports and would be subject to regulatory examination and possible enforcement actions. Such regulatory examinations may include periodic examinations, special, unscheduled examinations without notice, or other examinations as the SEC may prescribe.

Reports to Private Fund Investors. In addition to requiring submission of records and reports to the SEC, the Proposed Act specifically permits the SEC to adopt rules that would require advisers to provide the investors, prospective investors, counterparties, and creditors of their private funds with specified records, reports, and other documents. As this authority is not limited to the records and reports required to be filed with the SEC, the Proposed Act effectively opens the door for the SEC to prescribe requirements for private fund offering documents and periodic reports.

Confidentiality of Records and Clients. The Proposed Act authorizes the SEC to make private fund advisers' reports available to the Board of Governors of the Federal Reserve System and the Council for the purpose of assessing systemic risk in the global financial system or determining if a private fund should be treated as a Tier 1 financial holding company under the Bank Holding Company Act. The Proposed Act requires that any such reports remain confidential, although the exact scope of this confidentiality is not clear. Finally, the Proposed Act would eliminate the provision of the Advisers Act that generally prohibits the SEC from requiring a registered

[3] The Financial Services Oversight Council, as set forth in the Treasury's White Paper, *see* note 5 *infra*, will be comprised of eight members, including the Secretary of the Treasury (Chair of the Council), the Chair of the Board of Governors of the Federal Reserve System, the Chair of the Commodity Futures Trading Commission, the Directors of the Consumer Financial Protection agency, the Chair of the Federal Deposit Insurance Corporation, the Directors of the Federal Housing Finance Agency, the Director of the National Bank Supervisor, and the Chair of the Securities and Exchange Commission.

adviser to disclose the identity, investments, or affairs of its clients.

Open Issues and Potential Impact on Investment Advisers

Private fund advisers should consider the following implications and open issues related to the Proposed Act:

- **Thresholds for Assets Under Management and Number of Clients.** If enacted, the Proposed Act will require any investment adviser with greater than $30 million[4] in U.S. assets under management to register with the SEC under the Advisers Act, regardless of the number of clients the adviser has and regardless of whether any or all of those clients are "private funds." This requirement would effectively eliminate the "small adviser exception" for advisers with fewer than 15 clients currently provided by Section 203(b)(3) of the Advisers Act, forcing advisers such as family offices to register, even when the adviser has fewer than 15 family member clients and no advisory client is a "private fund." At the same time, "foreign private advisers" will remain exempt from SEC registration under the Proposed Act so long as they have fewer than 15 U.S. clients and fewer than $25 million in U.S. assets under management.

- **Books and Records.** Because the Proposed Act treats the books and records of each private fund as a book and record of the fund's adviser, the Proposed Act effectively requires advisers to keep, and authorizes the SEC to examine, books and records of each of the private funds advised by the adviser.

- **Scope of "Trading Practices" Information.** The Proposed Act requires an adviser to file records and reports with the SEC that disclose the adviser's "trading practices." This opens advisers up to a potentially broad range of disclosure items.

- **Client Anonymity.** The Proposed Act eliminates the provision of the Advisers Act that generally prohibited the SEC from requiring an adviser to disclose the identities of or private financial information about its clients. Although the Proposed Act does not yet include any provisions that specifically require the disclosure of client information, the proposed change—coupled with the broad powers of the SEC to require reporting and to examine the books and records of registered advisers—could impact venture capital and private equity funds in particular, as these funds historically have placed great emphasis on maintaining the privacy of the identities of their investors and portfolio companies.

- **Adviser Compensation.** Registered investment advisers may only be paid in a share of capital gains or capital appreciation (i.e., a performance fee or carried interest) if all of the adviser's clients are "qualified clients" as defined under Rule 205-3(d)(1) of the Advisers Act. In general, investors in private funds that rely on section 3(c)(7) of the Investment Company Act will be "qualified clients" and becoming subject to Rule 205-3 will not affect advisers to these funds. However, investors in funds that rely on section 3(c)(1) of the Investment Company Act may not be "qualified clients," so becoming subject to Rule 205-3 could jeopardize this compensation option for advisers of such 3(c)(1) funds.

- **Disclosure and Compliance.** Private fund advisers previously exempt from registration with the SEC would be subject to substantial regulatory requirements under the Proposed Act. Newly registered investment advisers would have to significantly create and update their policies and procedures to ensure compliance with reporting and retention requirements. In particular, each adviser would be required to establish a Code of Ethics under Rule 204A-1 under the Advisers Act, as well as appoint a Chief Compliance Officer and maintain a complete written compliance program under Rule 206(4)-7, if the Proposed Act becomes law. The Proposed Act would also effectively require advisory agreements to be in compliance with the Advisers Act and would require advisers to provide Form ADV Part II or a full private placement memorandum to its investors.

[4] Both the Treasury's Fact Sheet, *see* note 1 *supra*, and the Remarks by Assistant Secretary for Financial Institutions Michael Barr on Regulatory Reform to the Exchequer Club, Washington, D.C. (July 15, 2009), *available at* http://www.ustreas.gov/press/releases/tg213.htm, state that the Proposed Act will require the registration of all investment advisers with greater than $30 million in assets under management. This $30 million threshold is based on Rule 203A-1(a)(1) of the Advisers Act, which sets $30 million dollars of assets under management as the threshold for SEC registration by an investment adviser. Interestingly, the language of the proposed statute sets the minimum threshold for treatment as a "foreign private adviser" at $25 million rather than $30 million. Currently, Rule 203A-1(a)(2) of the Advisers Act allows, but does not require, investment advisers with between $25 million and $30 million of assets under management to register with the SEC.

- **Treatment as a Tier 1 Financial Holding Company.** The Proposed Act suggests that regulators will use the private fund advisers' disclosures to determine whether a particular fund should be treated as a "Tier 1" financial holding company. The administration's proposed Financial Regulatory Reform[5] treats certain financial holding companies, as defined by Section 2(p) of the Bank Holding Company Act, as "Tier 1" financial holding companies, meaning that because of a particular financial holding company's size, leverage, and interconnectedness, its failure would threaten the financial stability of the global financial markets. Such Tier 1 financial holdings companies are subject to increased regulation by the Council.

  Thus, the Proposed Act would allow the SEC to provide the Council with the reports and records of a private fund so that the Council could determine whether the particular private fund should be treated as a Tier 1 financial holding company and thus subject to heightened oversight by the Council.

- **Elimination of Exemption for Commodity Trading Advisors.** Under current law, investment advisers that are registered with the Commodities Futures Trading Commission (CFTC) as commodity trading advisors, who do not primarily engage in business as investment advisers to registered investment companies or business development companies, are not required to register under the Advisers Act. The Proposed Act would narrow the exception so that it no longer applies to such CFTC-registered commodity trading advisors whose business consists primarily of acting as investment adviser to a private fund.

- **Insurance Company Exception Remains Intact.** The Proposed Act has no effect on investment advisers whose only clients are insurance companies, who are currently excepted from the registration requirement under Section 203(b)(2) of the Advisers Act.

- **Grant of Authority to the SEC.** The Proposed Act would grant rulemaking authority to the SEC that would allow it to define the terms used in the Advisers Act, including express authority to define terms differently in different portions of the Advisers Act.[6]

Further Questions

If you have any questions concerning the information discussed in this FYI, please contact any of the following Morgan Lewis attorneys:

Philadelphia
Timothy W. Levin 215.963.5037 tlevin@morganlewis.com

New York
P. Georgia Bullitt 212.309.6683 gbullitt@morganlewis.com
Louis H. Singer 212.309.6603 lsinger@morganlewis.com
Jedd H. Wider 212.309.6605 jwider@morganlewis.com

Washington, D.C.
Steven W. Stone 202.739.5453 sstone@morganlewis.com

San Francisco
Paul C. McCoy 415.442.1385 pmccoy@morganlewis.com
Peter M. Phleger 415.442.1096 pphleger@morganlewis.com

Miami
Ethan W. Johnson 305.415.3394 ejohnson@morganlewis.com

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5 Department of the Treasury, White Paper: Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation (June 17, 2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

6 In 2006, the U.S. Court of Appeals for the District of Columbia Circuit struck down an SEC rule that would have required most hedge fund advisers to register with the SEC. *See Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). The Proposed Act would overcome that ruling because such adviser registration would be congressionally mandated.

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