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Legislation Passed by House Would Require Most Private Fund Advisers to Register with SEC

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The U.S. House of Representatives (House) recently passed legislation with proposed amendments to the Investment Advisers Act of 1940, as amended (Advisers Act) that would effectively require many investment advisers to private pools of investment capital to register with the Securities and Exchange Commission (SEC).[1] The legislation would have far-reaching implications for advisers of hedge funds, private equity funds, and other U.S.- and non-U.S.-domiciled private pools of investment capital. In contrast to prior legislative proposals, the House legislation would have more limited consequences for managers of venture capital funds.

Background

In response to the Obama administration's White Paper on Financial Reform, both the House and the U.S. Senate introduced bills seeking to overhaul the U.S. financial markets. The provisions of both bills relating to private fund advisers were largely based on legislation initially proposed by the U.S. Department of the Treasury in July 2009 (Proposed Treasury Regulations).[2] The initial House bill (H.R. 3818)—which only addressed registration of private fund advisers—was first introduced on October 15, 2009 and was referred to the full House on October 27, 2009.[3] As discussed below, the provisions of H.R. 3818 were subsequently included in a broader House bill. A discussion draft of the Senate bill was introduced on November 10, 2009 by Senator Christopher Dodd, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs (Dodd Bill).[4] Both H.R. 3818 and the Dodd Bill proposed to amend the Advisers Act to generally require registration of all private fund investment advisers.

On December 11, 2009 the House passed revised legislation, known as the Private Fund Investment Advisers Registration Act of 2009 (Proposal), as part of the broader Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173). The Proposal is the latest congressional attempt to facilitate the monitoring of systemic risk in the financial markets and to safeguard the investing public from fraud and abuse.

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1 *See* The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 11th Cong. (1st Sess.), Title V, Subtitle A, §§ 5001–5011 (as passed by House of Representatives, Dec. 11, 2009), ***available at*** http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/111_hr_finsrv_4173_full.pdf.

2 *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 Treasury legislation can be found online, ***available at*** http://www.treas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf. Morgan Lewis's prior LawFlash on the Proposed Treasury Regulations can be viewed at http://www.morganlewis.com/pubs/IMFYI_USTreasureyLegislation_17jul09.pdf.

3 *See* Private Fund Investment Advisers Registration Act of 2009, H.R. 3818, 111th Cong. (1st Sess.), §§ 1–7 (introduced Oct. 15, 2009, referred to House by Committee on Financial Services on Oct. 27, 2009), ***available at*** http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h3818ih.txt.pdf.

4 *See* Restoring American Financial Stability Act of 2009, 111th Cong. (1st Sess.) Title IV, §§ 401–414 (as introduced by Sen. C. Dodd on Nov. 19, 2009), ***available at*** http://banking.senate.gov/public/_files/AYO09D44_xml.pdf.

A summary of the Proposal as well as a brief summary of relevant sections of the Dodd Bill, both of which are currently before the Senate, are set forth below.

Summary of the Proposal

Definition of "Private Fund" and Registration Requirement. Under the Proposal, investment advisers of private funds must register with the SEC. The Proposal broadly defines "private fund." as any issuer that would be an investment company under the Investment Company Act of 1940, as amended (Investment Company Act) but for the exclusions from the definition of "investment company" under Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

This broad definition of "private fund" would effectively require many advisers to hedge funds or private equity funds to register with the SEC, subject to certain exceptions as set forth below. 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. Although the definition of "private fund" would also presumptively encompass venture capital funds, the Proposal directs the SEC to promulgate rules that would implement an exception to the registration requirements for advisers to "venture capital funds," as described further below.

Definition of "Foreign Private Adviser." The Proposal 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 complies with all of the following:

- Has no place of business in the United States
- 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

Registration Exemption and Reporting Requirements of Advisers to Venture Capital Funds. Under the Proposal, an investment adviser to a "venture capital fund" would not have to register under the Advisers Act; however, the Proposal calls for the SEC to identify and define the term "venture capital fund." Despite the exemption from registration, advisers to venture capital funds would still be required to maintain such records and provide the SEC with such annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

Registration Exemption and Reporting Requirements of Advisers to Small Private Funds*.* The Proposal exempts from registration under the Advisers Act any investment adviser of private funds, if each such private fund has less than $150 million in U.S. assets under management; however, such advisers would be required to maintain such records and provide the SEC with such annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors. The Proposal does not indicate a limit on the number of such small private funds that an adviser may provide advisory services to and still qualify for the registration exemption.

Special Consideration for Advisers to Mid-sized Private Funds. With respect to investment advisers to "mid-sized" private funds, the Proposal calls for the SEC to tailor the registration, examination, and reporting requirements in consideration of the size, governance, and investment strategy of such funds and the SEC's determination of whether such funds pose systemic risk. However, the Proposal does not provide a definition of "mid-sized" private fund.

Exclusion of Advisers to Small Business Investment Companies. The Proposal excludes from registration requirements an adviser that solely advises small business investment companies that are licensed under the Small Business Investment Act of 1958 or are proceeding to qualify for such a license or are related to such a licensed small business and in the process of applying for an additional license.

Increased Regulatory Oversight and Disclosure. The Proposal would substantially increase the reporting requirements and regulatory oversight of private fund advisers who would be required to register. In general, 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 Proposal would also permit the SEC to require registered private fund advisers to file additional records and reports as the SEC, in consultation with the Board of Governors of the Federal Reserve System, may determine to be necessary or appropriate for the assessment of systemic risk.

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

SEC May Require Additional Information. The SEC may require the reporting of additional information from private fund advisers, regardless of whether the private fund adviser is registered with the SEC, as the SEC determines necessary. In making such determination, the SEC, taking into account the public interest and potential to contribute to systemic risk, may set different reporting requirements for different classes of private fund advisers, based on the particular types or sizes of private funds advised by such advisers.

Reports to Private Fund Investors. In addition to requiring submission of records and reports to the SEC, the Proposal specifically permits the SEC to adopt rules that would require advisers to provide 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 Proposal effectively opens the door for the SEC to prescribe requirements for private fund offering documents and periodic reports.

Confidentiality of Records and Clients. The Proposal authorizes the SEC to make private fund advisers' reports available to the Board of Governors of the Federal Reserve System (and to any other entity that the SEC identifies as having systematic risk responsibility) for the purpose of assessing systemic risk in the global financial system. The Proposal requires that any such reports remain confidential, although the exact scope of this confidentiality is not clear. Finally, the Proposal would eliminate the provision of the Advisers Act that generally prohibits the SEC from requiring a registered 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 Advisers Act:

- **Thresholds for Assets Under Management and Number of Clients.** Currently, Section 203(b)(3) of the Advisers Act exempts from registration advisers with fewer than 15 clients during the prior 12-month period, subject to certain other requirements. The Proposal eliminates this provision of the Advisers Act, which would effectively require a small adviser to register under the Advisers Act if it has at least $30 million in assets under management.[5] The Proposal does provide an exemption from registration for advisers to private funds if each of the funds has less than $150 million in U.S. assets under management regardless of the number of investors in the fund. At the same time, "foreign private advisers" will remain exempt from SEC registration under the Proposal so long as they have fewer than 15 U.S. clients and less than $25 million in U.S. assets under management.

[5] This $30 million threshold is based on Rule 203A-1(a)(1) of the Advisers Act, which sets $30 million of assets under management as the threshold for SEC registration by an investment adviser. Interestingly, the language of the Proposal 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.

- **Acknowledgment of "Mid-sized Private Funds."** The Proposal acknowledges investment advisers to "mid-sized private funds," which seems to suggest that the reporting requirements for such advisers may be less extensive compared to large, private funds. This acknowledgment of "mid-sized" private funds, coupled with the exemption from registration for advisers to private funds with less than $150 million in U.S. assets under management, suggests that the drafters of the Proposal view the systemic risk to the financial system that private funds pose as a three-tiered structure, with large private funds being subject to both registration requirements and the most extensive reporting and recordkeeping requirements and examination procedures.

- **Records and Reports of Private Funds.** Because the Proposal treats the books and records of each private fund as a book and record of the fund's adviser, the Proposal effectively requires advisers to keep, and authorizes the SEC to examine, books and records of each of the private funds advised by the adviser. Furthermore, Section 203A(b)(3) of the Advisers Act under the Proposal would include a provision that allows the SEC to require additional information from private fund advisers as the SEC determines necessary, which was not contemplated by H.R. 3818. The language of the other provisions of Section 203A(b) under the Proposal implies that Section 203A(b)(3) would apply to both registered and unregistered private fund advisers. This reading of Section 203A(b)(3) would be consistent with the registration exemptions granted to advisers to venture capital funds and small private funds, which still require records and reports from such exempted advisers. This also suggests that the required information under Section 203A(b)(2) of the Advisers Act, as amended by the Proposal, would *not* apply to advisers that are exempt from registration.

- **Scope of "Trading Practices" Information.** The Proposal 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 Proposal 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 Proposal 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 private funds, which generally place 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. Under current Rule 205-3, a "qualified client" generally is a person who has $750,000 under management with the adviser, has a net worth (with spouse) of $1,500,000 or is a "qualified purchaser" under Section 2(a)(51) of the Investment Company Act. In general, investors in private funds that rely on Section 3(c)(7) of the Investment Company Act will be "qualified clients" and changes 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 changes to Rule 205-3 could jeopardize this compensation option for registered investment advisers of such 3(c)(1) funds. Under the Proposal, Section 205(e) of the Advisers Act would be amended to include a periodic inflation adjustment that would result in a periodic recalculation of the thresholds for determining qualified client status and would impact a registered investment adviser's ability to be paid in a share of capital gains or capital appreciation.

- **Disclosure and Compliance.** Private fund advisers previously exempt from registration with the SEC would be subject to substantial regulatory requirements under the Proposal. Newly registered investment advisers would have to create and/or update their policies and procedures to ensure compliance with reporting and retention requirements. In particular, if the Proposal becomes law, each adviser would be required to establish a Code of Ethics under Rule 204A-1 of the Advisers Act, as well as appoint a Chief Compliance Officer and maintain a complete written compliance program under Rule 206(4)-7. The Proposal 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.

- **Elimination of Exemption for Commodity Trading Advisers.** Under current law, investment advisers that are registered with the Commodities Futures Trading Commission (CFTC) as commodity trading

advisers, 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 Proposal would narrow the exception so that it no longer applies to such CFTC-registered commodity trading advisers whose business consists primarily of acting as investment adviser to a private fund.

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

- **Grant of Authority to the SEC.** The Proposal 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. However, the SEC would be prohibited from adopting a rule that defines "client" to include investors in a private fund advised by an adviser.[6]

Summary of the Dodd Bill

The private fund aspects of the Dodd Bill are similar to those of the Proposal, but there are several important differences. Unlike the Proposal, the Dodd Bill does not include an exemption for advisers of private funds with less than $150 million in U.S. assets under management and does not provide an exemption for advisers of small business investment companies. Under the Dodd Bill, advisers to private funds with more than $100 million of assets under management would be required to register with the SEC under the Advisers Act and disclose financial data needed to monitor systemic risk and protect investors. Advisers with less than $100 million of assets under management would be required to register with state authorities in the state where the adviser maintains its principal office.[7]

The Dodd Bill defines "private fund" as an issuer that (i) would be an investment company under the 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. The Dodd Bill excludes from the definition of "investment adviser" a "family office" and, like the Proposal, provides an exemption for venture capital fund advisers—although both "family office" and "venture capital fund" are subject to subsequent definition by the SEC. In contrast to the Proposal, the Dodd Bill provides an exemption from registration requirements for private *equity* fund advisers (whereas the Proposal exempts advisers to small private funds), although the definition of "private equity fund" and the formulation of certain reporting requirements for advisers to private equity funds will be determined by the SEC. Furthermore, the Dodd Bill does not contemplate special consideration or treatment for reporting requirements and examinations of "mid-sized" private funds, as the Proposal does.

For those advisers that are required to register, the financial data that must be reported under the Dodd Bill is similar to that required under the Proposal, but would also include information about the valuation methodologies used by the funds, the types of assets held by the funds, and any side arrangements or side letters whereby certain investors in the funds obtain more favorable rights than others. Other information may be requested by a new U.S. super-regulatory agency that would focus on systemic risk.

Conclusion

Advisers to private funds that rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act for exclusion from the definition of "investment company" should keep abreast of the various legislative proposals moving through the legislative process. Given the similarity of the Proposal and the Dodd Bill, which were both rooted in the Proposed Treasury Regulations, it seems that most private fund advisers will be subject to reporting requirements, although certain advisers to small private funds, venture capital funds, small business investment

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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 by defining private fund investors as "clients" of the fund manager. *See Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

7 This provision would make ineffective Rule 203A-1(a) under the Advisers Act, which currently sets $25 million in assets under management by a state-regulated investment adviser as an optional threshold for registration under the Advisers Act and $30 million in assets under management for such an adviser as a mandatory threshold for registration.

companies, or private equity funds may benefit from exemptions from registration under the Advisers Act. Such registration exemptions, however, may be somewhat hollow considering the potential for expansive reporting and examination requirements for unregistered advisers that are contemplated by both the Proposal and the Dodd Bill.

Set forth below are links to documents showing the proposed changes to the Advisers Act represented by the various legislative proposals discussed above, as well as the differences between the various legislative proposals. Morgan Lewis will continue to monitor the ongoing legislative process surrounding the registration of private fund advisers.

		Overwriting Document			
		Dodd Bill	H.R. 4173	H.R. 3818	Proposed Treasury Legislation
Base Document	Investment Advisers Act of 1940	Get PDF	Get PDF	Get PDF	Get PDF
	Proposed Treasury Legislation	Get PDF	Get PDF	Get PDF	
	H.R. 3818	Get PDF	Get PDF		
	H.R. 4173	Get PDF			

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