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## SENATE'S LATEST PROPOSAL TO OVERHAUL INVESTMENT ADVISER REGULATION

### PRIVATE CAPITAL AND INVESTMENT GROUP ALERT

*This Private Capital and Investment Group Alert provides only general information and should not be relied upon as legal advice. For more information, contact your Patton Boggs LLP attorney or one of the lawyers/authors listed below.*

Donald Moorehead  
202-457-5212  
[dmoorehead@pattonboggs.com](mailto:dmoorehead@pattonboggs.com)

Courtney Nowell  
202-457-6563  
[cnowell@pattonboggs.com](mailto:cnowell@pattonboggs.com)

Gregg Buksbaum  
202-457-6153  
[gbuksbaum@pattonboggs.com](mailto:gbuksbaum@pattonboggs.com)

Kevin Boardman  
214-758-3570  
[kboardman@pattonboggs.com](mailto:kboardman@pattonboggs.com)

Alexandra Metzner  
202-457-6028  
[ametzner@pattonboggs.com](mailto:ametzner@pattonboggs.com)

[WWW.PATTONBOGGS.COM](http://WWW.PATTONBOGGS.COM)

On March 15, 2010, U.S. Senate Banking Chairman Christopher Dodd (D-CT) released a discussion draft of the "Restoring American Financial Stability Act of 2010" (RAFSA), a measure that would provide for a historic overhaul of the financial services regulatory system. Title IV of the RAFSA is entitled, the "Private Fund Investment Advisers Registration Act of 2010" (PFIAR Act), which contains many similarities to the previous version of this Act contained in a comprehensive regulatory reform package distributed by Chairman Dodd in November 2009, and discussed in our [November 2009 Alert](#). In addition, there are many similarities to the Private Fund Investment Advisers Registration Act of 2009 (House Bill) contained in the Wall Street Reform and Consumer Protection Act of 2009 passed by the House on December 11, 2009, and discussed in our [December 2009 Alert](#).

The Senate Committee on Banking, Housing and Urban Affairs' (Committee) markup of the discussion draft of the PFIAR Act briefly occurred on March 22, 2010 with only the Manager's Amendment passing and the report moving out of Committee. All other amendments, including several from Senators Jack Reed (R-RI) and Richard Shelby (R-AL), will be considered later this spring once the bill moves to the Senate floor.

***"When we come back from recess, the No. 1 issue for the U.S. Congress will be this bill in the United States Senate."***

**-- Representative Barney Frank (D-MA)<sup>1</sup>**

Although there are many similarities, this Alert addresses the distinctions among the PFIAR Act, the prior version of this Act, and the House Bill.

#### Key Highlights of the PFIAR Act:

- Investment advisers to private funds, whether located in the U.S. or offshore, will be required to register, unless they do not meet the registration threshold or are otherwise exempted from registration.
- Investment advisers to venture capital funds, small business investment companies and family offices would be exempt from registration and reporting requirements.
- Investment advisers to private equity funds would be exempt from registration, but would have reporting requirements.
- No provision for the exemption of investment advisers to hedge funds, who appear to be a primary target of this legislation.
- The threshold for registration would be increased from \$25 million to \$100 million under Section 203A(a)(1)(A) of the Investment Advisers Act of 1940 (Advisers Act).
- The PFIAR Act would be effective one year after enactment of the RAFSA.

<sup>1</sup> Quote appeared in an article entitled "After Health Care Win, Democrats Put Financial Overhaul at Top of Agenda" on page B3 of the March 25, 2010 edition of *The New York Times*.

## **Advisers Required to Register: Expanded to Include Those Who Advise Onshore and Offshore Funds**

The PFIAR Act includes language similar to that in the House Bill, which eliminates the private fund adviser exemption contained in Section 203(b) of the Advisers Act. As such, an exemption from registration would no longer be available to an investment adviser of a “private fund,” which the PFIAR Act defines as a fund that would be an “investment company” under the Investment Company Act of 1940 (Company Act), but for the exceptions to that definition under Sections 3(c)(1) and 3(c)(7) of the Company Act. This definition would include all such funds wherever organized or located, whether in the U.S. or in offshore jurisdictions, unless otherwise exempted (as discussed below). The prior version of the PFIAR Act excluded only “private funds” organized in the U.S. or which were at least 10 percent-owned by U.S. persons.

The PFIAR Act would create a foreign private fund adviser exemption based, in part, on the exemption contained in Section 203(b)(3) of the Advisers Act, and would define the term “foreign private fund adviser” as an investment adviser who (1) has no place business in the U.S.; (2) has in total fewer than 15 clients that are resident in the U.S.; (3) has aggregate assets under management attributable to clients in the U.S. and investors in the U.S. in private funds advised by the investment advisor of less than \$25 million (or such higher amount as determined by the SEC); and (4) does not hold itself out to the public in the U.S. as an investment adviser, nor acts as an investment adviser to a registered investment company or a business development company. This definition closely resembles the one contained in the prior version of the PFIAR Act, albeit with the fourth element slightly expanded, and similarly resembles the one in the House Bill, except that the second and third elements dispense with the 12-month time requirement that the House Bill and the current Section 203(b)(3) of the Advisers Act contemplate. Thus, the current PFIAR Act casts a slightly wider net over foreign private fund advisers than the other proposals.

### **Assets under Management Threshold**

In connection with the existing requirement of an investment adviser regulated in the State in which it maintains a principal office to also register with the Securities and Exchange Commission (SEC), the PFIAR Act would raise the assets under management minimum of \$25 million, contained in Section 203A(a)(1)(A) of the Advisers Act, to \$100 million, thereby permitting a greater range of smaller investment advisers to avoid SEC registration under such exemption.

### **Venture Capital Fund Exemption**

Like the House Bill, the PFIAR Act includes an exemption from SEC registration and reporting for advisers to “venture capital funds.” However, it appears that the exemption from the registration and reporting requirements for such advisers is available only to the extent of the provision of investment advice to these funds.

As a result, depending on how the SEC would define the term “venture capital fund” (required within six months of enactment), it is unclear whether fund sponsors that manage both venture capital funds and other types of investment funds would be completely or partially exempt from, or would be subject to all, registration requirements. This uncertainty should be of particular importance to venture capital firms that have expanded beyond traditional venture capital investing by doing later-stage investing or engaging in a mix of investment styles within a single fund.

Unlike the House Bill, though, the PFIAR Act does not provide the SEC with the ability to impose recordkeeping and reporting requirements on venture capital fund advisers who are otherwise exempt from SEC registration.

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## **Private Equity Fund Exemption and Reporting Requirements**

Unlike the House Bill, the PFIAR Act would add a new subsection to Section 203 of the Advisers Act, which provides that investment advisers will not be subject to registration and general reporting requirements with respect to their provision of investment advice to private equity funds; however, unlike investment advisers to venture capital funds, investment advisers to private equity funds would have some reporting requirements.

The SEC would be required, within six months of enactment, to issue rules defining a “private equity fund” and outlining what records and annual reports advisers to private equity funds will be required to maintain and submit as necessary and appropriate in the public interest and for the protection of investors. As with venture capital funds, it is unclear whether fund sponsors that manage private equity funds as well as other types of private funds would be completely or partially exempt from registration requirements and/or from the recordkeeping and reporting requirements for private equity funds to be promulgated by the SEC.

## **Prospective SEC Rules Governing Private Equity and Venture Capital Funds**

In formulating rules for private equity and venture capital funds, the SEC would be permitted to take into account the fund size, governance, investment strategy, risk and other factors deemed appropriate in the public interest and to protect investors in order to create a tailored set of rules. Venture capital firms and private equity firms will need to pay close attention to the way in which the terms “venture capital fund” and “private equity fund” are defined by the SEC if the PFIAR Act (or the House Bill) is enacted. We would assume that based on historical actions by the SEC, these definitions may distinguish private equity and venture capital funds from hedge funds and other types of funds by reference to whether, and to what extent, such funds permit redemptions by investors.

## **Family Office Exemption**

Unlike the House Bill, the PFIAR Act would also exclude advisers to “family offices” from the definition of “investment advisers” under the Advisers Act, and thus, would exempt them from registering with the SEC. The SEC would be obligated to formulate rules (although no time period is defined for creating these rules) that would define “family office” and capture the SEC’s previous exemptive policy regarding family offices, and the variety of management and employment structures or arrangements in use. This broad mandate to consider all types of family office management and employment structures will serve to greatly relieve family offices, which are typically smaller operations, from regulatory burdens which could inhibit their investment returns.

## **Exemption for Small Business Investment Companies**

Consistent with the House Bill, the PFIAR Act would exempt advisers from registration and reporting who solely advise small business investment companies (SBICs) or entities that have received notice that they qualify as an SBIC, or affiliated entities of SBICs that have a pending application for an SBIC license.

## **Required Reporting: Descriptions of Side Letters and Types of Assets**

The PFIAR Act contains provisions for the collection of certain types of data from registered investment advisers and their managed private funds, and provides that any records of funds managed by such advisers will be considered to be the adviser's records, as well, for reporting purposes. However, the PFIAR Act goes further than the House Bill in requiring certain information, such as information concerning side arrangements or side letters with investors.

The specific information that will be required to be maintained and subject to inspection by the SEC includes: (i) amount of assets under management and use of leverage, (ii) counterparty credit risk exposure, (iii) trading and investment positions, (iv) valuation policies and practices of the underlying funds, (v) the types of assets the funds hold, (vi) side arrangements or side letters with investors, (vii)

trading practices and (viii) other information deemed necessary or appropriate by the SEC for the protection of investors or for the assessment of systemic risk, which may include the establishment of different classes of fund advisers based on size or type of fund being advised. This list of items will greatly expand the reportable information that registered investment advisers are currently obligated to report and may, in certain respects, be greeted with some resistance by participants in the private fund community (e.g., investing positions, side letters, trading practices).

We expect that both fund sponsors and investors will be highly sensitive to any side arrangement or side letter disclosure requirements. Another important distinction to note, though, is that the PFIAR Act requires only “a description of” the disclosed records and reports, whereas the House Bill seems to require actual copies of its required list of disclosure items. It is unclear from the language of the PFIAR Act the breadth and extent to which records and reports would need to be “described,” including whether the identities of investors with side arrangements or side letters would need to be disclosed.

### **Loosening Prohibition against Disclosure**

The PFIAR Act would widen the exceptions to Section 210(c) of the Advisers Act, which in its current form severely limits the SEC’s ability to require a registered investment adviser to disclose the identity, investments or affairs of its clients. This would be achieved by allowing disclosure for the assessment of potential systemic risk, and permitting the SEC to create rules and regulations to define terms used in the PFIAR, such as “private equity fund”, “venture capital fund” and “client.”

### **Systemic Risk Oversight and Non-Disclosure of Proprietary Information and Confidentiality**

Although there is expanded authority to collect data, the PFIAR Act also provides that any proprietary information<sup>2</sup> of a registered investment adviser ascertained in required reporting will be subject to the same limitations on public disclosure as any facts collected during an exam by the SEC. Registered advisers will be subject to periodic and special examinations of their books and records by the SEC, which will be required to provide data to the Financial Stability Oversight Council (Council) that is necessary for assessing systemic risk posed by a private fund. However, the information filed with the SEC will be kept confidential except that disclosure will be required to Congress when accompanied by the proper confidentiality agreement, and will also be required to be disclosed to any other federal department or agency or a potential self-regulatory organization, or pursuant to an order of a U.S. court.

Although not expressly stated in the Act, we would expect that these confidentiality obligations and limitations on disclosure would extend to investment advisers to private equity funds who are exempt from registration, but nonetheless have certain reporting obligations.

### **SEC and CFTC Joint Rulemaking**

The PFIAR Act, like the House Bill, mandates that the SEC and the Commodity Futures Trading Commission (CFTC) have twelve months following enactment of the legislation to jointly promulgate rules to establish the form and content of reports required to be filed with the SEC and CFTC by investment advisers registered with both agencies.

### **Accredited Investor Status**

The PFIAR Act would require the SEC, under its rulemaking authority, to increase the financial thresholds for determining a natural person’s “accredited investor” status under the Securities Act of

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<sup>2</sup> “Proprietary information” is defined to include sensitive, non-public information concerning the investment adviser’s investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property, and any additional information the SEC determines to be proprietary.

1933 from their current thresholds of (a) annual income of \$200,000 for each of the prior two years (or \$300,000 for married couples) or (b) \$1,000,000 in net assets. The SEC would be required to make such upward adjustments as it sees fit in the public interest and at least once every five years to reflect the percentage increase in the cost of living. It is not clear precisely what measure (official or unofficial) the SEC would use to determine cost of living increases, but it is likely that a consumer price inflation index would be used.

## **Safeguarding Client Assets**

The PFIAR Act permits the SEC to promulgate rules requiring advisers to take steps to safeguard clients' assets over which the adviser has custody. The SEC is also permitted, under the PFIAR Act, to require the verification of these assets by an independent public accountant. These provisions are more permissive than language that was included in the prior version of the PFIAR Act, which required the SEC to prescribe rules that would require registered investment advisers to use an independent custodian to hold client assets, where necessary and appropriate in the public interest and for the protection of investors. Advisers required to register under the PFIAR Act, or already registered under the Advisers Act, would be well served to develop, to the extent not already in existence, policies and procedures regarding safeguarding client assets in the advisers' custody.

## **Clarification of Rulemaking Authority**

Like the House Bill, the PFIAR Act would clarify the SEC's rulemaking authority, permitting the SEC to issue, amend and rescind rules and regulations defining technical, trade and other terms used in the PFIAR Act, but the SEC will not be permitted to define the term "client" to include a single investor in a private fund managed by an investment adviser if the private fund has entered into an advisory contract with the advisor. However, unlike the House Bill, the PFIAR Act does not generally direct the SEC how, for example, categorizing types of private funds, should be done. This would provide the SEC with flexibility to create rules and definitions with respect to the PFIAR Act as it sees fit.

## **Comptroller General and SEC Studies**

Finally, the PFIAR Act directs the Comptroller General of the U.S. to, within one year following enactment of the PFIAR Act, study (i) whether a self-regulatory fund body for private funds could work and (ii) the appropriate thresholds for "accredited investor" status and eligibility to invest in private funds. The Division of Risk, Strategy and Financial Innovation at the SEC is directed to conduct a study, within two years following enactment of the PFIAR Act, on the state of short selling, including the effect of the newer short sale rules and subsequent trading behaviors, with any recommendations for market improvements, including consideration of real time reporting of short sale positions. The PFIAR Act would also require the SEC to report to Congress annually as to how it has used the data it has collected from private funds and their advisers.

## **Effective Date**

The PFIAR Act would go into effect on the one-year anniversary of its enactment, although investment advisers may register with the SEC prior to such date pursuant to rules and regulations prescribed by the SEC.

## **Other Provisions of RAFSA That May Affect Investment Advisers**

### **SEC Study on Investor Access to Information on Investment Advisers and Broker-Dealers**

The RAFSA, through the Manager's Amendment, would require the SEC to conduct a study and propose recommendations within six months of enactment that would examine ways to improve investor access to registration information concerning registered and previously registered investment advisers, broker-dealers and all of their associated persons. The study would (i) identify additional information that should be publicly available, (ii) consider whether the Central Registration Depository

and Investment Adviser Registration Depository systems should be combined and (iii) identify what data points should be displayed for investors and in what format. Within 18 months of submitting the study, the SEC would be required to implement any recommendations.

## Dissolution Authority over Non-Bank Financial Institutions

Like the House Bill, under the RAFSA, resolution authority would be given to the Federal Deposit Insurance Corporation (FDIC) to wind down large, financially-troubled non-bank financial institutions, and to set up a \$50 billion dollar systemic dissolution fund within the U.S. Treasury, (amount adjusted for inflation periodically by the FDIC), known as the Orderly Liquidation Fund (Liquidation Fund).

The Liquidation Fund would be initially capitalized, beginning one year after enactment of the RAFSA until not less than five years later, but no more than 10 years later, by fees charged to “eligible financial companies.”<sup>3</sup> These fees would be based upon individual risk assessments conducted by the FDIC and the SEC based on several factors. However, after the initial capitalization, the FDIC is permitted to make additional assessments on eligible financial companies and “financial companies”<sup>4</sup> with consolidated assets over \$50 billion that are not “eligible financial companies.”

While we would expect that most fund sponsors would not reach this \$50 billion threshold for fee assessment, several of the larger sponsors could be assessed fees to fund the Liquidation Fund if the Board of Governors of the Federal Reserve determines to supervise such fund sponsors as nonblank financial companies.

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We will continue to monitor developments and the progress of the legislation and other related initiatives within Congress and the administration in order to advise our clients and friends from time to time. Please do not hesitate to contact your Patton Boggs attorney or one of the lawyer/authors listed above with any inquiries.

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<sup>3</sup> The RAFSA defines “eligible financial company” as (A) any bank holding company with consolidated assets equal to or greater than \$50 billion and (B) any nonbank financial company supervised by the Board of Governors. A “nonbank financial company supervised by the Board of Governors” is defined as a nonbank financial company (either U.S. or foreign) that the Board of Governors has determined will be supervised by the Board of Governors.

<sup>4</sup> The RAFSA defines a “financial company” as a company that: (A) is incorporated or organized under Federal law or the laws of any State and (B) is (i) a bank holding company as defined in Section 2(a) of the Bank Holding Company Act of 1956 (BHCA), (ii) a nonbank financial company supervised by the Board of Governors under the orderly liquidation authority, (iii) any company predominately engaged in activities that are financial in nature or incidental thereto for purposes of Section 4(k) of the BHCA or (iv) any subsidiary of a company described in clauses (i) – (iii) above, other than an insured depository institution or insurance company.