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THE STATUS OF PROPOSED LEGISLATION FOR INCREASED REGULATION OF INVESTMENT ADVISERS AND THE PRIVATE FUNDS THEY MANAGE

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

Courtney Nowell
202-457-6563
cnowell@pattonboggs.com

Gregg Buksbaum
202-457-6153
gbuksbaum@pattonboggs.com

Amy Davine Kim
202-457-5667
akim@pattonboggs.com

Alexandra Metzner
202-457-6028
ametzner@pattonboggs.com

WWW.PATTONBOGGS.COM

After some five years of controversy, Congress seems prepared to enact legislation that would require most U.S.-based advisers to private investment funds (including hedge funds and private equity funds) to register with the U.S. Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940 (Advisers Act). Proposals to require registration of these advisers and/or the funds they advise have been advanced in Congress for several years following a decision of a Federal Court of Appeals in 2006 holding that the SEC lacked authority to require registration under its existing statutory authority.¹

Most recently, the Obama administration opted for investment adviser registration as part of its comprehensive regulatory reform and restructuring legislative initiative and forwarded specific legislation, entitled the "Private Fund Investment Advisers Registration Act of 2009" (Treasury Bill) to Congress on July 15, 2009. The administration's broader proposals also provide an additional level of regulatory oversight of those private investment funds that, based on reports to be provided to the SEC under the Treasury Bill, are deemed by reason of their size or otherwise to be systemically significant.

This memorandum contains a brief summary of the principal provisions of the Treasury Bill and contrasts several of its more important provisions with those contained in bills introduced by members of Congress,² as those bills may be reviewed by the relevant congressional committees as they act on the Treasury Bill. We expect that both the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs will ultimately approve the Treasury Bill, perhaps with amendments, as there appears to be little private sector opposition in principle to adviser registration, in contrast to other proposals that would require the private investment funds, themselves, to register. While the Treasury Bill is likely to be approved as a separate measure by each committee, we currently expect that it will be combined with other components of the administration's regulatory reform package, including possibly the proposal to establish a consumer financial products commission.³

General Overview of the Treasury Bill

The Treasury Bill proposes to eliminate and modify certain investment adviser registration exemptions in the Advisers Act, which would require previously unregistered investment advisers with more than \$30 million in assets under management to register with the SEC. The bill also would expand record-keeping maintenance and reporting requirements for registered investment advisers and indirectly expose private investment funds to SEC monitoring and possible examination. Finally, the bill is aimed at providing the SEC with access to information it would not otherwise have access to in order to assess whether funds and fund activity pose systemic risk to the financial markets.

Registration Requirements

The Treasury Bill proposes to amend the Advisers Act by eliminating the current “private adviser” exemption from SEC registration for investment advisers who:

- have less than 15 clients; and do not hold themselves out to the public as investment advisers or act as investment advisers to any registered investment company or business development company.
- in place of this exemption, the Treasury Bill proposes an exemption for “foreign private advisers,” defined as investment advisers who:
 - have no place of business in the United States;
 - have fewer than 15 clients and less than \$25 million⁴ in assets under management during the prior 12 months; and
 - do not hold themselves out to be investment advisers or act as investment advisers to any registered investment company or business development company.⁵

As a result, the Treasury Bill would require all investment advisers to private investment funds, who have an office in the United States and more than \$30 million⁶ in assets under management to register with the SEC under the Advisers Act⁷.

The Treasury Bill also proposes to narrow two additional registration exemptions: (1) the in-state exemption of Section 203(b)(1) of the Advisers Act⁸ and (2) the Commodities and Futures Trading Commission (CFTC) exemption of Section 203(b)(6) of the Advisers Act. The Treasury Bill would exclude advisers to “private funds”⁹ from relying on the in-state exemption and would include “private funds” in the list of prohibited advisory clients for registered CFTC advisors¹⁰.

Collection of Systematic Risk Data, Reports and Examinations

Under the Treasury Bill, the SEC would be permitted to require registered investment advisers to make available and maintain records subject to examination and to submit reports as “necessary or appropriate in the public interest and for the assessment of systematic risk” by the Board of Governors of the Federal Reserve System (Board of Governors) and the Financial Services Oversight Council, which is proposed to be formed under the CFPB. The records and reports of private funds advised by registered investment advisers would be deemed to be the investment adviser’s own records, and thus, would also be accessible to the SEC and subject to examination. Among the details that would be required in the reports on an individual fund basis are:

- assets under management;
- use of leverage;
- counterparty credit risk exposures;
- trading and investment positions and trading practices; and
- other information that the SEC, in consultation with the Board of Governors, determines necessary or appropriate.

The Reed Bill also proposes the foregoing additional reporting and record requirements, although it does not specify the content of the reports to be submitted. However, it goes further than the Treasury Bill by explicitly reaching underlying funds. For purposes of providing reports to the SEC and maintaining certain records, the Reed Bill proposes that any companies for which a registered investment adviser or its affiliates act as a sponsor, underwriter, distributor, placement agent, finder or in a similar capacity, and would otherwise be “investment companies” under the Investment Company Act of 1940 (the Company Act), but are not so classified due to the Section 3(c)(1) or 3(c)(7) exceptions (less than 100 shareholders or all shareholders are “qualified purchasers”, respectively), would also be required to keep records and provide reports as already required under the Company Act.

Disclosures

Under the Treasury Bill, the SEC would not be required to disclose any supervisory report or information contained therein, but it is not authorized to withhold information from Congress nor prevented from complying with a request for information from any federal department or agency or any self-regulatory organization requesting information within the scope of its jurisdiction, or complying with a U.S. court order in an action brought by the United States or the SEC. The bill also proposes to broaden the SEC’s ability to require registered investment advisers to disclose their clients’ identities, investments or affairs, by specifically deleting language in the Advisers Act that prohibits disclosure of such information.¹¹ The current language of Section 210(c) of the Advisers Act provides that disclosure will only be compelled where necessary or appropriate in a particular proceeding or investigation having as its object the enforcement of a provision of the Advisers Act. Therefore, under the Treasury Bill, it would not be necessary for a proceeding or investigation to exist for the SEC to require disclosure of client information.

Clarification of Rulemaking Authority

Under the Treasury Bill, Section 211 of the Advisers Act would be amended to permit the SEC to ascribe different meanings to terms (including the term “client”) used in different sections of the Advisers Act as the SEC deems necessary.¹² Along with the SEC’s existing power in Section 211 to “classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters,” this suggests that the SEC may have the flexibility to distinguish among and apply different regulatory standards to advisers to different types of investment funds – be it private equity funds, venture capital funds, hedge funds or otherwise. In addition, the Treasury Bill provides that the SEC and the CFTC, after consultation with the Board of Governors, have six months after the date of the enactment of the Treasury Bill to jointly create rules for the form and content of reports to be filed with the SEC and the CFTC by investment advisers that are registered under both the Advisers Act and the Commodity Exchange Act. This provision, which promotes cooperation between the SEC and the CFTC, dovetails with other similar efforts to bring the two agencies closer together in monitoring market participants who operate in both the SEC’s and CFTC’s fields of play.

ANALYSIS

Regulation of Private Funds vs. Investment Advisers

The primary focus of the Treasury Bill is on the regulation of investment advisers, whereas the primary focus of a bill introduced earlier this year, the Hedge Fund Transparency Act of 2009, S.334 (HFTA), by Senators Grassley (R-IA) and Levin (D-MI) on January 29, 2009, was on the regulation of the private funds sponsored and managed by investment advisers. HFTA seeks to place additional conditions and requirements on private funds relying on the registration exemptions contained in Sections 3(c)(1) and 3(c)(7) of the Company Act, including requiring such private funds to register with the SEC, electronically file an annual information form, maintain books and records as required by the SEC and comply with information requests or examinations by the SEC. Accordingly, this suggests that the legislative agenda in this area may have shifted its focus from direct regulation of private funds to more stringent regulation of investment advisers so that disclosure of information regarding a particular fund or group of funds could be indirectly obtained through their advisers.

Consistent among the various legislative proposals and in the dialogue in Washington is that the increased regulation would not distinguish among the types of private pools of capital. Managers of private equity funds, venture capital funds, hedge funds, real estate funds and a myriad of other types of investments funds would all arguably be governed by such regulation. While many in the hedge fund industry have welcomed additional regulation to standardize reporting requirements, managers of venture capital funds oppose increased regulation, stating that the manner in which their funds operate and invest place all the risk on their investors and do not pose systemic risks to the financial markets. The differences of opinion highlight the difficulty of drafting generally applicable regulations to private investment funds and investment advisers.

Congressional Action

It is likely that one or more of the recently introduced bills will be added to or consolidated with the administration's regulatory reform package of legislation as opposed to being passed as a standalone bill. Of particular note, a hearing for consideration of the CFPA by the House Financial Services Committee is currently scheduled for September 23 or 24, 2009, and could serve as a barometer for these fund transparency legislative efforts, although Congress' focus on health care upon reconvening its session may cause the fund transparency bills to slip in priority.

The Treasury Bill, if passed or included as part of other legislative packages, will compel greater numbers of investment advisers to register with the SEC and broaden the SEC's access to information on the operations and performance of investment advisers and the private funds they manage.

Checklist for Investment Advisers

Should legislation of the type discussed above be enacted, we recommend that investment advisers who are not already registered with the SEC take, or seek assistance in taking, the following steps in anticipation of potential requirements to register with the SEC:

- prepare Form ADV disclosures;
- appoint a chief compliance officer;
- adopt a formal compliance program with adequate resources;
- adopt a code of ethics;
- develop a books and records policy; and
- establish operating committees (investment, brokerage/best execution, valuation and compliance/risk).

Although it is difficult to predict with any certainty the final outcome of the current legislative proposals, we will continue to monitor developments and the progress of the bills and other related initiatives within Congress and the administration in order to advise our clients and friends from time to time.

¹ In *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), the Federal Court of Appeals for the D.C. Circuit vacated the SEC's "hedge fund rule" requiring hedge fund advisers to register with the SEC under the Advisers Act if the funds they advise have 15 or more investors. Rule 203(b)(3)-2 promulgated under the Advisers Act contains the "private adviser" exemption, which allows advisers with less than 15 "clients" over the past 12 months to avoid registration. Prior to creating the "hedge fund rule," a fund, itself, was deemed a single client. Upon creation of the rule, though, the SEC equated each individual investor as a client. However, the court in *Goldstein* rejected the SEC's position holding that the adviser's duties run to the fund and not the individual investors, thereby vacating the "hedge fund rule."

² The Private Fund Transparency Act of 2009, S.1276, was introduced by Senator Reed (D-RI) on June 16, 2009 (Reed Bill); the Financial System Stabilization and Reform Act, H.R. 1754, was introduced by Congressman Castle (R-DE) on March 26, 2009; and the Hedge Fund Study Act, H.R. 713, was introduced by Congressman Castle (R-DE) on January 29, 2009.

³ Such proposal is contained in a bill entitled, the Consumer Financial Protection Agency Act of 2009, H.R. 3126, introduced by Congressman Frank (D-MA) on July 8, 2009 (CFPA). A hearing on this bill is scheduled for the latter part of September 2009.

⁴ Or such higher amount as the SEC may, by rule, deem appropriate.

⁵ The Reed Bill also proposes to amend the Advisers Act by eliminating the exemption for "private advisers" and replacing it with the "foreign private advisers" exemption.

⁶ Although the Treasury Bill and the Reed Bill include a threshold amount for assets under management in respect of the "foreign private advisers" exemption, neither bill provides a specific threshold amount for registration. However, Rule 203A-1 promulgated under the Advisers Act provides that if the state in which an investment adviser's principal office and place of business has enacted an investment adviser statute, such adviser is not required to register with the SEC unless it has at least \$30 million in assets under management, as reported on its Form ADV. The Rule also provides that such an adviser with at least \$25 million, but less than \$30 million, in assets under management has the option to register with the SEC.

⁷ The in-state exemption excepts advisers from registration whose clients reside within the state of the adviser's principal office and place of business and that does not issue advice or analysis on publicly-traded securities.

⁸ The CFTC exemption excepts advisers (i) who are registered with the CFTC as commodity trading advisors, (ii) whose primary business is not acting as an investment advisor and (iii) no advisory services are provided to investment companies and business development companies.

⁹ "Private funds" include investment companies exempted under Sections 3(c)(1) and 3(c)(7) of the Company Act and that are either organized in the United States or 10 percent or more of its securities are owned by U.S. persons.

¹⁰ The Reed Bill does not contain these two additional registration exemptions.

¹¹ Proposed deletion of Section 210(c) of the Advisers Act. The Reed Bill contains substantially the same provisions as the Treasury Bill in this regard.

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Donald Moorehead
202-457-5212
dmoorehead@pattonboggs.com

Courtney Nowell
202-457-6563
cnowell@pattonboggs.com

Gregg Buksbaum
202-457-6153
gbuksbaum@pattonboggs.com

Amy Davine Kim
202-457-5667
akim@pattonboggs.com

Alexandra Metzner
202-457-6028
ametzner@pattonboggs.com

WASHINGTON DC | NORTHERN VIRGINIA | NEW JERSEY | NEW YORK | DALLAS | DENVER | ANCHORAGE | DOHA | ABU DHABI