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UPDATE ON SENATE INVESTMENT ADVISER REGISTRATION LEGISLATION

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.

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On November 10, 2009, U.S. Senate Banking Chairman Christopher Dodd (D-CT) released a discussion draft of the "Restoring American Financial Stability Act of 2009" (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 2009" (PFIAR), which contains many similarities to legislation approved by the House Financial Services Committee (HFSC) on October 27th and pending a vote on the House floor (Kanjorski Bill) discussed in our [October 2009 Alert](#). At the November 19, 2009 executive session of the Senate Committee on Banking, Housing and Urban Affairs, in which Committee members were given the opportunity to offer opening statements on the RAFSA discussion draft, no statements were made concerning the PFIAR. Chairman Dodd concluded the session by announcing that proposed amendments to RAFSA would be postponed until the week after Thanksgiving, when the markup process will begin.

There are certain differences between the PFIAR and the Kanjorski Bill, including those which in some cases reverse, and in other cases expand upon, the legislative work done in the House. This Alert addresses the distinctions between the PFIAR and the Kanjorski Bill.

Advisers Required to Register: Limited to Those Who Advise Onshore Funds

The PFIAR reverts to language similar to the discussion draft of the Kanjorski Bill, providing a new definition for the term "private fund" under the Investment Advisers Act of 1940 (Advisers Act), and limiting the scope of the registration requirement to advisers to funds that are either organized in the United States or that have ten percent or more of their outstanding securities (by value) owned by U.S. persons. This is a retreat from the HFSC's amendments to the Kanjorski Bill discussion draft, which would extend the Securities and Exchange Commission's (SEC) reach to advisers to funds organized in offshore jurisdictions, unless otherwise exempted (as discussed below).

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 SEC, the PFIAR 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 Kanjorski Bill, the PFIAR includes an exemption from SEC registration for advisers to venture capital funds. However, it appears that the exemption from the registration requirements is only with respect to the provision of investment advice to a

venture capital fund. As a result, depending on how the SEC would define the terms "venture capital fund" and "private equity fund" (as discussed below), 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 Kanjorski Bill, though, the PFIAR 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. For the investment adviser that is engaged strictly in venture capital, the PFIAR would seem to be a more advantageous legislative proposal.

Reporting Requirements with Respect to "Private Equity Funds"

The PFIAR would add a new subsection to Section 203 of the Advisers Act, which provides that investment advisers not subject to registration and reporting requirements with respect to their provision of investment advice to private equity funds would still need to maintain such records and provide to the SEC such annual or other reports with respect to those private equity funds as the SEC deems necessary and appropriate in the public interest and for the protection of investors. This is in distinct contrast to the venture capital fund exemption in the PFIAR discussed above, which does not mandate that unregistered advisers to venture capital funds maintain and provide such records to the SEC (at least insofar as they advise venture capital funds). This new subsection of Section 203 would task the SEC with issuing final rules on the records and reports requirement and defining the term "private equity fund" within six months following enactment of the legislation. Venture capital firms and more traditional 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 (or other legislation with similar provisions) is enacted.

Family Office Exemption

In a significant move that would be beneficial for certain participants in the industry, the PFIAR excludes from the definition of "investment adviser" any family offices, which would necessarily exempt family offices from registration requirements. The SEC, though, would be charged with defining the term "family office."

Required Reporting: Side Letters and Types of Assets

As in the Kanjorski Bill and in other legislative proposals to revise the Advisers Act, the PFIAR provides a list of the kinds of records and reports of a registered adviser and the funds it manages that are required to be filed with the SEC. However, the PFIAR goes further than those legislative efforts in that it requires reporting of side arrangements or side letters, as well as the types of assets held. 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 PFIAR requires only "a description of" the disclosed records and reports, whereas the Kanjorski Bill seems to require actual copies of its required list of disclosure items. It is unclear from the language of the PFIAR 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. It may be that in drafting the PFIAR it is Chairman Dodd's intention to let the SEC specify the parameters of such disclosure requirements under its rulemaking authority.

Systemic Risk Oversight

The Kanjorski Bill provides that information collected by the SEC from registered advisers would be shared, for systemic risk assessment purposes, with the Board of Governors of the Federal Reserve System and any other entity that the SEC identifies as having systemic risk responsibility. The PFIAR contains virtually identical provisions to enable the SEC to collect information and to mandate such sharing with systemic risk regulators. However, it names the Agency for Financial Stability (AFS), alone, as the systemic risk regulator, which would be a new Federal regulator created under the RAFSA charged with policing firms and practices that present systemic risk to the health of the entire financial system. This appears consistent with Chairman Dodd's efforts to reduce the risk oversight role played by the Federal Reserve, and to limit its focus to monetary policy, which is counter to the HFSC's apparent efforts to expand the Federal Reserve's role consistent with the Obama administration's agenda.

SEC and CFTC Joint Rulemaking

Like the original discussion draft of the Kanjorski Bill, the PFIAR mandates that the SEC and the Commodity Futures Trading Commission (CFTC) have six 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. The amended Kanjorski Bill, though, had increased the time period to twelve months following enactment of the legislation.

Accredited Investor Status

While not addressed in any prior legislative proposals pertaining to the regulation of investment advisers, the PFIAR 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 1933, which currently require (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 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 price inflation index would be used.

Independent Custodians

The PFIAR also enlists 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. It is reasonable to imagine that the drafters of this legislation had hedge funds in mind when drafting this provision since hedge fund assets traditionally have consisted of the type of securities that are liquid or otherwise appropriate for a custodian to hold. However, it is difficult to envision how more traditional private equity assets such as a controlling ownership interest in a privately-held company or a promissory note would be held by a custodian. While many hedge fund advisers already use independent custodians, if this legislation is enacted, private equity firms, in particular, will want to follow any rules issued by the SEC in this regard.

Comptroller General Studies

Finally, the PFIAR calls for the Comptroller General of the U.S. to conduct the following studies: (i) within one year, on the appropriate criteria for determining

“accredited investor” status and eligibility to invest in “hedge funds”;¹ (ii) within one year, the feasibility of forming a self-regulatory fund body to oversee hedge funds, private equity funds and venture capital funds; and (iii) within two years, the state of short selling in the stock market, including the impact of recent short sale rule changes and the incidence of failure to deliver short sold shares.

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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.

¹ It is unclear why hedge funds were explicitly named to the exclusion of other types of funds.