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UPDATE ON HOUSE OF REPRESENTATIVES INVESTMENT ADVISER REGISTRATION LEGISLATION AND OTHER DEVELOPMENTS AFFECTING INVESTMENT ADVISERS**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 December 10, 2009, the U.S. House of Representatives approved “The Wall Street Reform and Consumer Protection Act of 2009” (Wall Street Reform Act), which was introduced by Representative Barney Frank (D-MA). It is a comprehensive financial regulatory reform proposal containing a number of components aimed at reforming various facets of the financial services industry, among which is the “Private Fund Investment Advisers Registration Act of 2009” (House Bill). The House Bill is unrelated to similarly-named legislative initiatives introduced in recent months¹ and discussed in our Alerts issued earlier this fall ([September](#), [October](#) and [November](#)).

Among the primary elements of the House Bill, this Alert discusses the following:

- Elimination of the private fund adviser exemption from registration.
- Collection of specific types of data from investment advisers and the funds they manage.
- Non-disclosure and confidentiality obligations of the Securities and Exchange Commission (SEC) with respect to proprietary information of investment advisers and the funds they manage.
- Registration and reporting exemptions for investment advisers to venture capital funds.
- Registration and reporting exemptions for certain investment advisers to private funds, as well as registration and examination requirements for advisers to “mid-sized” private funds.
- SEC’s periodic determinations of new dollar amount thresholds for determining investor eligibility.
- Annual fees imposed on registered investment advisers to help recover the cost of inspections and examinations of such registered advisers.

The Wall Street Reform Act encompasses individual bills previously approved by the House Financial Services Committee and reflects portions of the Obama Administration’s previously announced initiatives for an overhaul of the U.S.

financial regulatory framework. It is difficult at this time to predict whether the Wall Street Reform Act will be enacted as it will need to be reconciled with a Senate proposal, the “Restoring American Financial Stability Act” (RAFSA), which also contains provisions for expanded registration of investment advisers ([as discussed in our November 20, 2009 Alert](#)). RAFSA has yet to be reported out of the Senate Committee on Banking, Housing and Urban Affairs and will most likely be formally considered by the Senate Committee towards the end of January 2010.

Investment Adviser Registration

Elimination or Limitations on Certain Exemptions

The House Bill would eliminate the private fund adviser exemption contained in Section 203(b) of the Investment Advisers Act of 1940 (Advisers Act). As such, an exemption from registration would no longer be available to an investment adviser of a “private fund,” which the House Bill 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 off-shore jurisdictions.²

The House Bill would leave in place the foreign private fund adviser exemption already contained in the Advisers Act, but defines the term “foreign private fund adviser” to mean an investment adviser (i) with no place business in the U.S; (ii) during the preceding 12 months, (a) has had in total fewer than 15 clients and investors in the U.S. in private funds advised by the investment adviser, and (b) aggregate assets under management attributable to clients and investors in the U.S. in private funds advised by the investment adviser of less than \$25 million; and (iii) does not hold itself out to the public as an investment adviser, nor acts as an investment adviser to a registered investment company or a business development company. This definition of “foreign private fund adviser” is unique among the other legislative proposals modifying the foreign private fund adviser exemption. Whereas other proposals define foreign private fund advisers as those having fewer than 15 clients, the House Bill’s threshold for a foreign private fund adviser is “15 clients and investors in the U.S. in private funds advised by the investment adviser.” It is not clear how the House Bill, if enacted, would be reconciled with the current Rule 203(b)(3)-1 promulgated under the Advisers Act, which provides a safe harbor that generally allows a private fund to be considered a “single client.”

Unlike the other legislative proposals, the House Bill would exempt from registration any investment advisers to licensed small business investment companies (SBICs), entities that have received from the Small Business Administration notice to proceed to qualify for a license, or applicants related to licensed SBICs which have license applications pending.

In addition, the House Bill would add language to Section 203(c) of the Advisers Act obligating the SEC to consider the relative risk profile of different classes of private funds as it establishes the rules and regulations for the registration of investment advisers to private funds.

Collection of Data

The House Bill contains provisions for the collection of certain data from investment advisers and the funds they manage, which provisions mirror those previously included in the Kanjorski Bill. In particular, the SEC would be authorized to require any registered investment adviser to maintain records of and file with the SEC reports regarding the private funds they manage, which the SEC may disclose to the Board of Governors of the Federal Reserve and to the Financial Services Oversight Council, a new systemic risk regulator proposed to be created under the Wall Street Reform Act.

Information to be disclosed in respect of private funds would include: amount of assets under management, use of leverage, counterparty credit risk exposures, trading and investment positions, trading practices, and such other information as deemed appropriate. The SEC would also be authorized to set different reporting requirements for different classes of private fund advisers based on the types and sizes of funds advised.

To allow this disclosure of fund data, the House Bill would eliminate Section 210(c) of the Advisers Act, which currently severely limits the SEC's ability to require an investment adviser to disclose the identity, investments or affairs of its clients.

Non-Disclosure of Proprietary Information and Confidentiality

Although the House Bill grants the SEC expanded authority to collect data, the House Bill also provides that any proprietary information³ of an investment adviser ascertained by the SEC through required reporting will be subject to the same limitations on public disclosure as any facts collected during an exam by the SEC.⁴ Further, the SEC may not be able to compel private funds to disclose proprietary information to counterparties and creditors.

Exemption of and Reporting by Venture Capital Fund Advisers

The House Bill contains substantially the same registration exemption for advisers to “venture capital funds” as contained in the Kanjorski Bill. Specifically, the SEC would be tasked with defining the term “venture capital fund,” and although advisers to venture capital funds would be exempt from registration, they would be required to maintain records and provide annual or other reports as the SEC deems necessary.⁵

Exemption of and Reporting by Certain Private Fund Advisers

The House Bill also contains a registration exemption for advisers to private funds where the investment adviser acts solely as an adviser to private funds and has less than \$150 million of assets under management. Notwithstanding this registration exemption, such private advisers would still be required to maintain records and provide annual and other reports to the SEC as it deems necessary.⁶

In addition, the House Bill contains a provision under which the SEC would be obligated to prescribe regulations for the registration and the examination of advisers to “mid-sized” private funds (to be defined by the SEC) taking into account the size, governance and investment strategy of such funds. It is not clear whether “mid-sized” will be defined in accordance with the \$150 million threshold discussed above.

Clarification of Rulemaking Authority

The House Bill clarifies the SEC’s rulemaking authority granting the SEC authority to issue, amend and rescind rules and regulations defining technical, trade and other terms used in the House Bill. In particular, the SEC may classify investment advisers and funds based upon their size, scope, business model, compensation scheme or potential to create or increase systemic risk. And in doing so, the SEC may prescribe different requirements for different classes of such advisers and funds and generally ascribe different meanings to terms used in different sections of the House Bill.

Comptroller General Study

Under the House Bill the Comptroller General of the U.S. would be directed to perform a study to assess the annual costs on industry members and their investors due to registration requirements and ongoing reporting requirements, and to submit a report to Congress no later than the second anniversary of the date of the House Bill’s enactment.⁷

Effective Date

The House Bill 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.

Qualified Client Standards

The House Bill proposes that the SEC periodically determine new dollar amount thresholds used as factors in determining a person’s financial sophistication, experience and knowledge as may be required to enter into a contract with an investment adviser. The SEC’s first determination of new threshold amounts, based on the effects of inflation, would be due within one year following the enactment of the House Bill, and thereafter, every five years.

Annual Assessments

Under Section 7302 of the Wall Street Reform Act, the SEC would be directed to establish rules to collect fees from registered investment advisers to help recover the cost of inspections and examinations of such registered advisers. Such fees would be payable upon registration and during each fiscal year thereafter in an amount that is “fair and reasonable” as determined by the SEC, which shall consider the following factors: the investment adviser’s size; the number of

clients of the investment adviser; the types of clients of the investment adviser; and such other relevant factors as the SEC deems appropriate. The aggregate fees that would be determined by the SEC are required to be greater than the amount the SEC spent on inspections and examinations of registered investment advisers during the 2009 fiscal year. Fee rates would be reviewable by the SEC and adjustments could be made before the end of a fiscal year. Penalties for late payment of fees could also be assessed by the SEC.

Other Developments that May Affect Investment Advisers

Dissolution Authority Over Non-Bank Financial Institutions

Under the Wall Street Reform Act, resolution authority would be given to the Federal Deposit Insurance Corporation (FDIC) to wind down large, financially-troubled non-bank financial institutions. A \$150 billion dollar systemic dissolution fund would be set up for this purpose. The fund would be capitalized by fees charged to “financial companies” with more than \$50 billion in assets, on a consolidated basis, and those financial companies that *manage* hedge funds⁸ with \$10 billion or more of assets under management on a consolidated basis. These fees would be based upon individual risk assessments conducted by the FDIC and the SEC, based on several factors.

The Wall Street Reform Act defines “financial company” as any company that: (A) is incorporated or organized under Federal law or the laws of any State; (B) is (i) a bank holding company as defined in Section 2(a) of the Bank Holding Company Act of 1956 (BHCA), (ii) any company subject to stricter prudential regulation under Section 1103 of the Wall Street Reform Act⁹, (iii) any insurance company, (iv) any company predominately engaged in activities that are financial in nature or incidental thereto for purposes of Section 4(k) of the BHCA¹⁰ or activities that have been identified for stricter prudential standards under Section 1103 of the Wall Street Reform Act, or (v) any subsidiary of a company described in clauses (i) – (iv) above that is a member of the Securities Investor Protection Corporation, other than an insured depository institution or any broker or dealer registered with the SEC; and (C) is not a Federal home loan bank, the Federal National Mortgage Association, or the Federal Home Loan Mortgage Corporation.

Taxation of Carried Interest

On December 9, 2009, the Tax Extenders Act of 2009, H.R. 4213, introduced by Chairman Charles Rangel (D-NY) of the House Ways and Means Committee (Rangel Proposal), passed in the House. This is one of several legislative proposals focused on changing the taxation of carried interest from capital gains to ordinary income.¹¹

The Rangel Proposal would require carried interest received by fund sponsors to be treated as ordinary income rather than capital gain. Like the other legislative proposals, the Rangel Proposal allows a fund sponsor to invest its own capital in a fund partnership and receive income taxed as capital gain with respect to its investment, so long as the amount treated as

capital gain is “reasonably related” to the amount of capital contributed. Therefore, with respect to a fund sponsor’s capital interest in a fund — as a general partner and/or a limited partner — any income earned would be taxable as capital gain. However, any carried interest earned, which is distinct from the fund sponsor’s capital interest, would be taxable as ordinary income. The Rangel Proposal would be effective for tax years beginning in or extending into 2010, and is estimated to generate \$24.6 billion over ten (10) years.

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 lawyers listed above with any inquiries.

Circular 230 Notice: To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (a) avoiding penalties under the Internal Revenue Code, or (b) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

¹ Recent unrelated legislative proposals of the same name include: the “Private Fund Investment Advisers Registration Act of 2009” (Treasury Bill) introduced by the Obama Administration on July 15, 2009; the “Private Fund Investment Advisers Registration Act of 2009” (Kanjorski Bill) introduced by Representative Paul E. Kanjorski (D-PA), chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, issued in discussion draft on October 1, 2009, and thereafter introduced as H.R. 3818 on October 15, 2009; and the “Private Fund Investment Advisers Registration Act of 2009” (Dodd Bill) included in Title IV of the “Restoring American Financial Stability Act of 2009” introduced by Senator Christopher Dodd (D-CT), Chairman of the Senate Committee on Banking, Housing and Urban Affairs.

² This differs from the definition for “private fund” contained in the Dodd Bill, which is limited to funds organized in the U.S. or which are at least 10%-owned by U.S. persons.

³ “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 proprietary.

⁴ Such limitations are contained in Section 210(b) of the Advisers Act, which limits public disclosure of such facts by the SEC, or any member, officer or employee thereof, except with the approval of the SEC, or in cases which are the subject of a public hearing or pursuant to a resolution or request from Congress.

⁵ We note that while the Dodd Bill also has an exemption from registration for venture capital fund advisers, it does not impose any recordkeeping and reporting requirements on such advisers.

⁶ This is in slight contrast to the Dodd Bill, which contains a registration exemption for advisers to “private equity funds,” which the SEC would be required to define under that Act.

⁷ This provision differs from the “study” provision contained in the Dodd Bill, which enumerates three other kinds of studies: (i) the appropriate criteria for determining “accredited investor” status and eligibility to invest in hedge funds; (ii) the feasibility of forming a self-regulatory body to oversee hedge funds, private equity funds and venture capital funds; and (iii) 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.

⁸ Under this legislation, the FDIC would have the authority to define the term “hedge fund” in consultation with the SEC.

⁹ Section 1103 of the Wall Street Reform Act provides that the Financial Services Oversight Council will subject a financial company to stricter prudential standards if the Financial Services Oversight Council determines that (1) material financial distress at the company could pose a threat to financial stability or the economy or (2) the nature, scope, size, scale, concentration, and interconnectedness, or mix of the company’s activities could pose a threat to financial stability or the economy, which determination is based on the following criteria: (i) the amount and nature of the company’s financial assets; (ii) the amount and nature of the company’s liabilities, including the degree of reliance on short-term funding, (iii) the extent of the company’s leverage; (iv) the extent and nature of the company’s off-balance sheet exposures; (v) the extent and nature of the company’s transactions and relationships with other financial companies; (vi) the company’s importance as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the financial system; (vii) the nature, scope and mix of the company’s activities; (viii) the degree to which the company is already regulated by one or more Federal financial regulatory agencies; and (ix) any other factors that the Financial Services Oversight Council deems appropriate.

¹⁰ Section 4(k)(4) of the BHCA defines activities that are financial in nature to include: (A) Lending, exchanging, transferring, investing for others, or safeguarding money or securities; (B) Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State; (C) Providing financial, investment, or economic advisory services, including advising an investment company (as defined in section 3 of the Investment Company Act of 1940); (D) Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly; (E) Underwriting, dealing in, or making a market in securities; (F) Engaging in any activity that the Board has determined, by order or regulation that is in effect on the date of the enactment of the Gramm-Leach-Bliley Act, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto (subject to the same terms and conditions contained in such order or regulation, unless modified by the Board); (G) Engaging, in the United States, in any activity that: (i) a bank holding company may engage in outside of the United States; and (ii) the Board has determined, under regulations prescribed or interpretations issued pursuant to subsection (c)(13) (as in effect on the day before the date of the enactment of the Gramm-Leach-Bliley Act) to be usual in connection with the transaction of banking or other financial operations abroad; (H) Directly, or indirectly acquiring or controlling, whether as principal, on behalf of 1 or more entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls), or otherwise, shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates, or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section if: (i) the shares, assets, or ownership interests are not acquired or held by a depository institution or subsidiary of a depository institution; (ii) such shares, assets, or ownership interests are acquired and held by: (I) a securities affiliate or an affiliate thereof; or (II) an affiliate of an insurance company described in subparagraph (I)(ii) that provides investment advice to an insurance company and is registered pursuant to the Investment Advisers Act of 1940, or an affiliate of such investment adviser; as part of a bona fide underwriting or merchant or investment banking activity, including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment; (iii) such shares, assets, or ownership interests are held for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the activities described in clause (ii); and (iv) during the period such shares, assets, or ownership interests are held, the bank holding company does not routinely manage or operate such company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition; (I) Directly or indirectly acquiring or controlling, whether as principal, on behalf of 1 or more entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls) or otherwise, shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section if: (i) the shares, assets, or ownership interests are not acquired or held by a depository institution or a subsidiary of a depository institution; (ii) such shares, assets, or ownership interests are acquired and held by an insurance company that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities; (iii) such shares, assets, or ownership interests represent an investment made in the ordinary course of business of such insurance company in accordance with relevant State law governing such investments; and (iv) during the period such shares, assets, or ownership interests are held, the bank holding company does not routinely manage or operate such company except as may be necessary or required to obtain a reasonable return on investment.

¹¹ Several additional legislative proposals focused on changing the taxation of carried interest from capital gains to ordinary income are circulating including (i) a proposal by Rep. Sander Levin (D-MI) that would tax carried interest income as ordinary income earned for investment management services introduced in April 2009 (Levin Proposal) and (ii) the Obama administration proposal described in the May 2009 Treasury Department's explanation of revenue provisions contained in the president's budget (Obama Proposal). The Levin Proposal and the Obama Proposal are discussed in detail in Patton Boggs' [October Alert](#) on the taxation of carried interest.