



**Tannenbaum Helpern
Syracuse & Hirschtritt** LLP

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House of Representatives to Consider Private Fund Investment Advisers Registration Act of 2009

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On October 27, 2009, the House Financial Services Committee (the “Committee”) passed, by a 67-1 vote, a bill designated H.R. 3818, as amended, otherwise known as the “Private Fund Investment Advisers Registration Act of 2009” (hereinafter referred to as the “Registration Act”). The Registration Act seeks to amend several provisions of the Investment Advisers Act of 1940, as amended (the “Advisers Act”). If passed into law, the Registration Act would require many hedge fund managers and managers of other private pools of capital (except for venture capital fund advisors and perhaps certain advisors to commodity pools) to register with the Securities and Exchange Commission (the “SEC”). The Registration Act would also require registered investment advisers to comply with new and expansive information reporting requirements in an attempt to collect systemic risk data, which raises questions about how such data will be stored and used and whether it will be made available to the public. Furthermore, the Registration Act clarifies and expands the SEC’s rulemaking authority and ability to interpret terms used in the Advisers Act. Now that the Committee has passed the Registration Act, it will at some point be considered and voted upon by the full House of Representatives. The following discussion summarizes and explains the Registration Act and compares it to similar bills pending in the 111th Congress.

¹ This GlobalNote® memorandum provides general information on the subject matter described, and it should not be relied on as legal advice on any matter in any jurisdiction. You should seek specific legal advice before acting with regard to the subjects discussed herein. For further information, please see the firm’s website: www.thshlaw.com. In addition, the Registration Act is subject to change, and there is no assurance that it will be signed into law either in its current form, in an altered form or at all. The discussion herein is current as of the date first written above.

I. Summary

Registration of Investment Advisers

Most significantly, the Registration Act imposes a mandatory registration requirement on many advisers to private pools of capital. The Registration Act accomplishes this by deleting the language in Sec. 203(b)(3) of the Advisers Act (the “private investment adviser exemption”). Under Sec. 203(b)(3), an investment adviser is exempt from SEC registration if (i) during the preceding 12 months, it had fewer than 15 “clients” (i.e., natural persons, or the corporation, limited partnership, limited liability company, trust or other legal entity serving as the investment vehicle it advises),² (ii) does not hold itself out generally to the public as an investment adviser and (iii) does not advise any registered investment company or business development company. Since many investment advisers advise a small number of funds or individuals, they have relied on the private investment adviser exemption to provide investment advisory services to clients in an unregistered capacity.

In addition, advisers to “private funds” would be prevented from relying on Sec. 203(b)(1) of the Advisers Act, which is a registration exemption for investment advisers whose clients are residents of the same state in which such investment advisers maintain their principal office and place of business, and which do not furnish advice or issue analyses or reports with respect to listed securities. The Registration Act would define the term “private fund” under Sec. 202(a) of the Advisers Act as an investment fund that would be an investment company under the Investment Company Act of 1940, as amended (the “Company Act”), but for the exception from that definition by either Sec. 3(c)(1) or Sec. 3(c)(7) thereunder.³ Since most privately offered hedge funds and private equity funds operate pursuant to one of these exceptions, this term captures most privately offered pools of capital, especially hedge funds and private equity funds, but not necessarily all commodity pools as discussed below.

The term “private fund” also captures offshore funds beneficially owned by at least one U.S. investor whether or not its investment adviser is domiciled in the U.S. Conversely, an offshore fund whose beneficial owners are comprised solely of non-U.S. investors would not be a private fund regardless of the domicile of its investment adviser. This is because the Company Act would not apply to such fund and, therefore, it would not have to rely on an exception from the definition of the term “investment company” to avoid Company Act registration. Accordingly, an offshore fund with no U.S. beneficial

² See, Advisers Act Rules 203(b)(3)-1(a)(1) and 203(b)(3)-1(a)(2)(i). The Registration Act also contains an amendment that prevents the SEC from redefining the term “client” to mean the investors in a private fund instead of the fund itself.

³ Sections 3(c)(1) and 3(c)(7) are separate exceptions from the definition of “investment company” that issuers can rely on if they are not publicly offering their securities. Issuers relying on the Section 3(c)(1) exception must also limit ownership of their outstanding securities to not more than 100 beneficial owners, whereas issuers relying on the Section 3(c)(7) exception must limit ownership of their outstanding securities to not more than 499 persons who are “qualified purchasers,” as defined in Sec. 2(a)(51)(A) of the Company Act.

owners would not be a private fund, even if it is advised by a U.S. investment adviser.⁴ However, a U.S. domiciled investment adviser advising an offshore fund beneficially owned exclusively by non-U.S. persons would likely have to register with the SEC because (i) the Registration Act does not provide the SEC with any specific authority to exempt from the registration requirement U.S. investment advisers to such offshore funds and (ii) as mentioned above, the private investment adviser exemption would be eliminated by the Registration Act.

Certain Exemptions from the Registration Act’s Registration Requirements

The Registration Act gives the SEC authority to provide certain exemptions from the new mandatory registration requirements. First, the Registration Act’s new Sec. 203(l) authorizes the SEC to provide an exemption from registration to any investment adviser to private funds if *each* of such private funds has assets under management in the United States of less than \$150,000,000. Such advisers still would be required to maintain such records and provide to the SEC such annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

When drafting an exemption pursuant to new Sec. 203(l), the SEC will need to resolve certain issues not addressed in the Registration Act. First, the Registration Act does not require an investment adviser to aggregate the assets of all of the private funds it advises. It also does not address managed accounts. Accordingly, the effect of the Registration Act would be that an investment adviser could advise two private funds, each of which having \$125 million in assets, and such investment adviser would not be required to register with the SEC. The \$150 million threshold also must be read together with Advisers Act Rule 203A-1, which sets a minimum registration eligibility threshold for investment advisers of at least \$30 million in assets under management. Since the Registration Act does not modify the Advisers Act rules, it appears that investment advisers with aggregate assets under management of less than \$30 million (including managed accounts) still will not be permitted to register. Nonetheless, investment advisers advising a single managed account with assets of \$30 million or more would likely have to register because the \$150 million exemption applies only to private funds, not managed accounts. Accordingly, if the SEC grants the \$150 million exemption pursuant to its authority under the Registration Act, more managed account advisers than private fund advisers could be subject to the registration requirement. It remains to be seen whether the SEC will try to amend the rules under the Advisers Act to eliminate this incongruity.

The Registration Act also exempts from mandatory registration “foreign private fund advisers,” another new term introduced into Sec. 202(a).⁵ Investment managers

⁴ This is the effect of an amendment to the discussion draft of the Registration Act, submitted by Committee Chairman Barney Frank and Representative Paul Kanjorski during the Committee mark-up session, which eliminated a requirement that at least 10% of the outstanding securities of a fund be owned by U.S. persons for it to be considered a “private fund.”

⁵ The term “foreign private fund adviser” means an investment adviser who (a) has no place of business in the United States; (b) during the preceding 12 months has had (i) fewer than 15 clients in the United States

formed in a non-U.S. jurisdiction with no place of business in the U.S. that wish to remain outside the new registration regime would have to be vigilant to ensure that the assets attributable to their U.S. “clients” (as defined above) remain below the \$25 million threshold.⁶ Given how low this threshold is, it would not be surprising to see many non-U.S. investment advisers preferring not to form funds domiciled in the U.S. (thereby foregoing capital that could be raised from taxable U.S. investors) rather than becoming subject to the Registration Act’s registration requirement, although the SEC could raise this threshold in its discretion. Also, it is not clear whether the “no place of business in the United States” prong of the “foreign private fund adviser” definition renders a non-U.S. investment adviser ineligible for the registration exemption if it has any affiliate in the U.S. (even one that does not provide investment advisory services).

A third exemption from the Registration Act’s registration requirement applies to advisers to venture capital funds. Interestingly, even though the Registration Act purports to define the term “private fund” as a proxy for hedge funds and other privately offered funds, it leaves to the SEC the task of defining “venture capital fund” in addition to the task of crafting an exemption from registration for venture capital fund advisers.⁷ Although there may be a plausible argument that venture capital funds pose less of a systemic risk than funds relying on leverage to enhance returns, this ignores the fact that venture capital funds can have a higher risk profile than some hedge funds or private equity funds and present the same risk of loss as other funds. It also ignores the fact that there are non-venture capital funds that do not utilize leverage and therefore pose no more systemic risk than a venture capital fund.

Lastly, the Advisers Act already contains a registration exemption for investment advisers registered as commodity trading advisers with the Commodity Futures Trading Commission (the “CFTC”) whose business does not consist primarily of acting as an “investment adviser” (as defined in the Advisers Act). The Registration Act amends this exemption by making it inapplicable to registered commodity trading advisors that advise private funds. The Registration Act does not address commodity trading advisors that are not registered with the CFTC because they qualify for an exemption from such

and (ii) assets under management attributable to clients in the United States of less than \$25,000,000 (or such higher amount as the SEC may determine); and (c) neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to any registered investment company, or a company which has elected to be a business development company pursuant to the Company Act.

⁶ Since the term “client” continues to mean the fund and not the investors, there is no look through to the underlying investors. This means that an investment adviser with no place of business in the U.S. that advises a fund domiciled outside the U.S. with U.S. investors in that fund would not be required to register with the SEC.

⁷ It remains to be seen what the definition of “venture capital fund” would entail, but there is clearly a belief among those on the Committee (whether true or not) that venture capital funds do not pose the same systemic risk that other private funds do. For example, Rep. Paul Kanjorski, who sits on the Committee and submitted the Registration Act for the Committee’s consideration, stated to the press that the SEC needs more information about hedge funds and private-equity firms because of the leverage they can wield and the risks they bring to the entire system, whereas venture-capital investors “are not highly leveraged people.” See, <http://www.marketwatch.com/story/bill-sets-rules-for-hedge-funds-and-private-equity-2009-10-27>.

registration. However, if such entities are advising “pure” commodity pools that fall outside the purview of the Company Act altogether, it follows that such commodity trading advisors would be immune to the registration provisions of the Registration Act whether or not they are registered with the CFTC.⁸

Substantial Information Reporting Requirements

The Registration Act also amends Sec. 204(b) of the Advisers Act to give the SEC new authority to impose robust information reporting requirements on registered investment advisers to private funds. The SEC is authorized by the Registration Act to require any registered investment adviser to maintain such records of and file with the SEC such reports regarding private funds advised by the investment adviser *as are necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk* as the SEC determines in consultation with the Board of Governors of the Federal Reserve System. The SEC is also authorized to provide or make available to the Board of Governors of the Federal Reserve System, and to any other entity that the SEC identifies as having systemic risk responsibility, those reports or records or the information contained therein. The records and reports required to be maintained or filed with the SEC must include, for each private fund advised by the investment adviser (a) the amount of assets under management; (b) the use of leverage (including off-balance sheet leverage); (c) counterparty credit risk exposures; (d) *trading and investment positions*; (e) *trading practices*; and (f) *such other information as the Commission, in consultation with the Board of Governors of the Federal Reserve System, determines necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.*

Clearly, the scope of authority granted to the SEC and the nature of the information to be reported to the SEC would be considered quite intrusive by many in the investment advisory industry and leaves open questions such as how the SEC expects to handle the information and what level of confidentiality it will be afforded. Perhaps the most troublesome element of new Sec. 204(b) is that “systemic risk” is not defined, yet the SEC can use assessment of systemic risk (or the public interest or investor protection if it wishes) to justify almost any new information reporting requirement it imposes on registered investment advisers. These standards are too ambiguous or broad to place any meaningful restriction on the SEC’s authority. The Registration Act also provides no assurances that such information will be kept confidential from the public.

Indeed, the Registration Act gives the SEC the power under revised Sec. 204(b) to require a registered investment adviser to provide such reports, records, and other documents to *investors, prospective investors, counterparties, and creditors* of any private fund advised by the investment adviser as the SEC may prescribe as necessary or

⁸ Determining whether a commodity pool falls outside the purview of the Company Act usually requires an analysis of its investment strategy. However, a “pure” commodity pool that only trades futures contracts is not likely to be an investment company within the meaning of the Company Act, would not need to be excepted from the definition of investment company under Sections 3(c)(1) or 3(c)(7) of the Company Act, and therefore would not be considered a “private fund” under the Registration Act.

appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. This is effectively a public disclosure requirement. Nonetheless, disclosure of such information would be a foreseeable reality particularly given the fact that the Registration Act deletes Sec. 210(c) of the Advisers Act, a provision protecting investment advisers from being required to disclose the identity, investments, or affairs of their clients to the SEC.

Enhanced SEC Authority to Interpret Provisions of the Advisers Act

The Registration Act would provide the SEC with enhanced rulemaking authority to define terms used in the Advisers Act, including to classify persons or matters within its jurisdiction based on the size, scope, business model, compensation scheme, or potential to create or increase systemic risk. The SEC may also prescribe different requirements for different classes of persons and ascribe different meanings to terms used in different sections of the Advisers Act (including the term “client”, although, as mentioned above, the Registration Act specifies that the SEC cannot attribute a meaning to the term “client” that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser).

Transition Period

The amendments to the Advisers Act contained in the Registration Act would not take effect until one (1) year after its enactment, thereby providing a grace period within which investment advisers can register with the SEC. The Registration Act allows investment advisers to register earlier if they wish.

II. Comparison With Other Congressional Bills Affecting Private Funds and Private Fund Advisers

The Registration Act is actually the fourth bill considered by Congress this year that would require registration of investment advisers or the funds they advise. The other three are H.R. 711 (“The Hedge Fund Adviser Registration Act of 2009”), S. 344 (“The Hedge Fund Transparency Act of 2009”) and S. 1276 (“Private Fund Transparency Act of 2009”).

The Hedge Fund Adviser Registration Act of 2009

This bill was introduced in the Committee in January of 2009 and simply eliminates the 15-client exemption provided under Sec. 203(b) of the Advisers Act, thereby requiring most investment advisers to register with the SEC without making a distinction among the funds to which they provide investment advisory services. The Committee has not considered this bill since it was referred in January and it does not appear likely to do so given the momentum of support for the Registration Act and its referral for consideration by the full House of Representatives.

The Hedge Fund Transparency Act of 2009⁹

This bill was introduced on January 29, 2009, and has been referred to the Senate Committee on Banking, Housing, and Urban Affairs with no further action taken on it this year. The major difference between this bill and others is that it would amend the Company Act to require registration of funds themselves in some cases. The bill would eliminate Sections 3(c)(1) and 3(c)(7), thereby turning most investment funds into investment companies. However, funds that previously relied on Section 3(c)(1) would be exempted from registration under the Company Act (i) automatically, if they have assets, or assets under management, of less than \$50 million, or (ii) conditionally, if they have assets, or assets under management, of \$50 million or more (such funds being referred to herein as “large private funds”) and to the extent additional conduct and disclosure requirements are satisfied. Funds that are currently excepted from being defined as investment companies under the Company Act pursuant to Section 3(c)(7) would, instead, become investment companies under the Company Act subject to the SEC’s regulatory authority. However, they would continue to remain exempt from the Company Act’s general registration and filing requirements (i) automatically, if they are not large private funds, or (ii) conditionally, if they are large private funds and to the extent additional conduct and disclosure requirements are satisfied.

Large private funds seeking an exemption from registration under the Company Act would be required to register with the SEC; to file annual forms with the SEC containing information such as contact information for individual investors in the fund, an explanation of the fund’s ownership structure and the value of the fund’s assets. To remain exempt from the Company Act’s registration provisions, large private funds also would be subject to certain recordkeeping requirements and would be obligated to establish and enforce an anti-money laundering program according to prescribed rules.

Private Fund Transparency Act of 2009

This bill was referred to the Senate Committee on Banking, Housing, and Urban Affairs on June 16, 2009, with no further action taken on it this year. The bill bears a resemblance to the Registration Act in several respects. First, this bill eliminates the 15-client registration exemption of Sec. 203(b) just as the Registration Act does. It also provides a limited exemption from registration for “foreign private advisers” (defined exactly the same as “foreign private fund adviser” is defined in the Registration Act). This bill also would amend Sec. 204 to give the SEC authority to require any registered investment adviser to maintain such records and submit such reports *as are necessary or appropriate in the public interest* or for the *supervision of systemic risk* by any Federal department or agency, and to provide or make available to such department or agency those reports or records or the information contained therein, thereby raising the same questions about the scope of reporting and confidentiality as are raised by the Registration Act. It also does not define “systemic risk” even though, like the

⁹ For more information about this bill, please refer to this firm’s GlobalNote entitled, “The Hedge Fund Transparency Act,” which provides a comprehensive summary and is available at http://thshlaw.com/Publications/February_2008/The_Hedge_Fund_Transparency_Act.pdf.

Registration Act, it is posited as a fundamental reason for requiring more robust information reporting in the SEC's determination. Also, like the Registration Act, there is language in the bill providing that the SEC cannot withhold private fund reports from Congress and is not prevented from providing such reports to other federal agencies and organizations upon request. Finally, this bill also clarifies the SEC's authority to define terms used in the Advisers Act, including the term "client" (although without the Registration Act's limitation that the term "client" does not include investors in a fund). However, the bill lacks a definition of "private fund" (thereby not making a distinction among funds and not providing an exemption for venture capital funds), contains no exemption from registration based on an assets under management threshold and does not go as far as the Registration Act in prescribing the scope and content of reporting to the SEC.

Of the two bills pending in the Senate, the Private Fund Transparency Act bears the most resemblance to the Registration Act and could be considered the Senate's counterpoint to the Registration Act when considering a compromise bill, assuming each bill is passed in its respective chamber. However, it is too early to determine which of the four bills in Congress will eventually be passed by Congress and given to the President to be signed into law. Nonetheless, the Registration Act deserves close scrutiny because it has gone further in the lawmaking process than any of the other pending pieces of legislation discussed herein.

If you have any questions about the Registration Act or similar legislation pending in Congress, please do not hesitate to contact us.