

December 16, 2009

House Passes Bill Requiring Most Private Fund Investment Advisers to Register

On December 11, 2009, the U.S. House of Representatives passed “The Wall Street Reform and Consumer Protection Act of 2009” (H.R. 4173).¹ The bill sets forth a comprehensive set of financial regulatory reforms, including measures to: (i) create a systemic risk regulator; (ii) establish a resolution fund to dissolve large, systemically relevant non-banks; (iii) reform the regulation of the over-the-counter derivatives market; (iv) create a new Consumer Financial Protection Agency; and (v) require mandatory registration and regulation by the U.S. Securities and Exchange Commission (the “SEC”) for most private fund investment advisers. Included in the bill is the “Private Fund Investment Advisers Registration Act of 2009” (the “IA Registration Act”) which would eliminate the “private adviser exemption” from registration with the SEC under the U.S. Investment Advisers Act of 1940, as amended (the “Advisers Act”). The bill would require any investment adviser to a “private fund” to register with the SEC (subject to certain exemptions described below) and subject the private funds advised by such SEC-registered advisers to substantial regulatory reporting requirements.

Current Law. Currently, investment advisers with greater than \$30 million in assets under management (“AUM”) are required to register with the SEC unless they fall within an exemption. Private fund advisers have historically relied on the “private adviser exemption” under Section 203(b)(3) of the Advisers Act which exempts an adviser from registration if it: (i) had fewer than 15 clients during the preceding 12 months; (ii) does not hold itself out generally to the public as an investment adviser; and (iii) does not advise any registered investment companies or companies electing to be regulated as business development companies. For purposes of calculating the number of clients, each fund is generally counted as a single client (so long as the fund receives investment advice based on its investment objectives, rather than the separate investment objectives of its investors).

Proposed Legislation. The IA Registration Act eliminates the “private adviser exemption” described above. In addition, any investment adviser to a “private fund” would be required to register with the SEC. A “private fund” is defined as an issuer that would be an “investment company” under Section 3(a) of the U.S. Investment Company Act of 1940, as amended (the “Investment Company Act”), but for the exception provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Private equity funds, hedge funds

¹ For the full text of The Wall Street Reform and Consumer Protection Act of 2009, see <http://thomas.loc.gov/cgi-bin/query/z?c11:H.R.4173>; (the Private Fund Investment Advisers Registration Act of 2009 begins on page 1021 at Title V, Capital Markets, Subtitle A). In addition, for all amendments to the bill, see <http://thomas.loc.gov/cgi-bin/bdquery/D?d111:4:/temp/~bdi2xQ:/bss/111search.html>.

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and venture capital funds commonly rely on these provisions to avoid regulation as an investment company.

Exemptions Under the Proposed Legislation. Importantly, the bill provides the following exemptions (among others) from registration as an investment adviser with the SEC:

- any private fund adviser that “acts solely as an adviser to private funds and has AUM in the United States of less than \$150 million” (such an adviser would still be subject to certain recordkeeping and annual reporting requirements described below);
- any adviser to “venture capital funds” (which is to be defined by the SEC) (such an adviser would still be subject to certain recordkeeping and annual reporting requirements described below);
- any adviser that is a “foreign private fund adviser” defined as an investment adviser that: (a) has no place of business in the United States; (b) during the preceding 12 months has had (i) in total, fewer than 15 clients and investors in the United States in private funds advised by such investment adviser; and (ii) aggregate AUM attributable to clients and investors in the United States in private funds advised by such investment adviser of less than \$25 million; 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 investment company registered under the Investment Company Act; and
- any adviser to small business investment companies, which are regulated by the Small Business Administration.

In addition, in prescribing regulations (including registration and examination procedures) relating to advisers of “mid-sized private funds,” the SEC must take into account the size, governance and investment strategy of such funds to determine whether they pose systemic risk; however, the bill does not provide a definition of “mid-sized private funds”. Significantly, the bill also provides that the SEC “*shall take into account the relative risk profile of different classes of private funds as it establishes by rule or regulation, the registration requirements for private funds,*” which suggests that Congress is still considering registration of the fund itself (as distinct from an adviser).

Records and Reports of Private Funds. The records of any private fund advised by an SEC-registered adviser would be “deemed to be the records and reports of such investment adviser”. Such advisers would be required to maintain such records of and file with the SEC such reports regarding the private funds that they advise 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,” including for each private fund: the amount of AUM; the use of leverage (including off-balance sheet exposures); counterparty credit risk exposures; trading and investment positions; and other important information relevant to determining potential systemic risk. The SEC would be permitted to require reporting of additional information as the SEC determines necessary and to set different reporting requirements and rules for different classes of private fund advisers, based on the particular types or sizes of private funds. All records of a private fund maintained by an SEC-registered adviser would be subject at any time to such periodic, special and other examinations by the SEC. Importantly, private fund advisers who are exempt from registration with the SEC because they either advise “venture capital funds” or have AUM in the United States of less than \$150 million would still be subject to such recordkeeping and

reporting requirements as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

Information Sharing and Disclosures to Third-Parties of Certain Private Fund Information.

The SEC would be permitted to share copies of all reports and documents filed with or provided to it by an SEC-registered adviser with the Board of Governors of the Federal Reserve System and to the Financial Services Oversight Council as necessary for the purposes of assessing the systemic risk of a private fund. In addition, a registered adviser must provide reports to investors, prospective investors, counterparties and creditors of any private fund advised by such adviser as the SEC may prescribe as necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. The SEC may not compel a private fund to disclose certain proprietary information to counterparties and creditors, including sensitive, non-public information regarding the investment adviser's investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property.

SEC Rulemaking Authority. The IA Registration Act gives the SEC broad authority to issue, amend and rescind such rules and regulations as are necessary or appropriate to carry out the intent of the bill, including the ability to: (i) classify persons and matters within its jurisdiction based upon, but not limited to, size, scope, business model, compensation scheme or potential to create or increase systemic risk; (ii) prescribe different requirements for different classes of persons or matters; and (iii) ascribe different meanings to terms (including the term "client," except that the SEC cannot define the term "client" to include an investor in a private fund).

Effective Date. The IA Registration Act would take effect on the one-year anniversary of the date of the enactment of the legislation, during which time the SEC would be required to adopt rules and regulations providing procedures for registration.

Qualified Client Standard. The bill also provides that the net worth and/or asset-based qualifications applicable to a "qualified client" under the Advisers Act will be periodically adjusted for inflation by the SEC. Under current law, an SEC-registered adviser may only charge incentive or performance based fees to investors in a fund if they meet the "qualified client" standard set forth in Rule 205-3 of the Advisers Act.

Next Steps; Senate Version of IA Registration Act. The House has now concluded its work on financial regulatory reform, and the focus now shifts to the U.S. Senate and the Senate Banking Committee. In November, Senate Banking Committee Chairman Christopher Dodd introduced a sweeping financial regulatory bill that included a discussion draft of the Senate Banking Committee's version of the "Private Fund Investment Advisers Registration Act of 2009,"² which is substantially similar to the House bill with the following key differences:

- provides an exemption from registration (but not from certain recordkeeping and reporting requirements) for any adviser to a "private equity fund" (which is to be defined by the SEC);³

² For the full text of the Senate's discussion draft, see http://banking.senate.gov/public_files/AYO09D44_xml.pdf (the Private Fund Investment Advisers Registration Act of 2009 begins on page 291 at Title IV, Regulation of Advisers to Hedge Funds and Others).

³ When last tasked with distinguishing private equity funds from hedge funds, in connection with the Hedge Fund Adviser Registration Rule in 2005, the SEC used lock-up periods to distinguish private equity funds from hedge funds, which some speculate led to longer lock-ups in hedge funds in order to avoid registration.

- provides an exclusion from the definition of “investment adviser” under the Advisers Act for any “family office” (which is to be defined by the SEC);
- provides an aggregate AUM registration threshold of \$100 million;
- narrows the definition of a “private fund” by requiring that a private fund either is (i) organized in the United States or (ii) has 10% or more of its securities owned by United States persons (as a result, fewer funds would be captured by the Senate’s version);
- requires disclosure to the SEC of any “side arrangements or side letters whereby certain investors in a fund obtain more favorable rights or entitlements than other investors;”
- provides that the SEC shall prescribe rules requiring all SEC-registered advisers to use an independent custodian to hold client assets (although the SEC is permitted to do so only where necessary and appropriate for the protection of investors);
- does not contain third-party disclosure requirements;
- does not contain any reference to “mid-sized private funds;” and
- does not contain language specifically prohibiting the SEC from defining the term “client” as an investor in a private fund.

The Investor Protection Act. Included in the passage by the House of the omnibus Wall Street Reform and Consumer Protection Act of 2009 was the “Investor Protection Act of 2009”. Of significance to investment advisers, the House voted to delete a provision that would have given the Financial Industry Regulatory Authority (“FINRA”) oversight and rulemaking authority over investment advisers that are associated with broker-dealers. As a result, it appears that FINRA is out as a prospective self-regulatory organization for investment advisers.

Update; House Approves Tax Increase on Carried Interest. On December 9, 2009, the House approved the “Tax Extenders Act of 2009” (H.R. 4213)⁴ which included a provision that would tax certain carried interest income at ordinary income rates rather than at capital gains rates. The bill, which would be effective for taxable years beginning after December 31, 2009, would apply to carried interests in partnerships where the partner holds an “investment services partnership interest”. An investment services partnership interest is an interest held by a person who provides advisory, management, financing and other supporting services with respect to the acquisition, holding or disposing of securities, rental real estate, interests in partnerships, commodities, or options or derivatives with respect to any of the foregoing.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues discussed in this memorandum may be addressed to any of the following:

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⁴ For the full text of the Tax Extenders Act of 2009, see <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.4213>.