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Reconciling the Senate and House Versions of the Private Fund Investment Advisers Registration Act

On May 20, 2010, the United States Senate passed "The Restoring American Financial Stability Act of 2010" (the "Senate Bill"). The United States House of Representatives passed its own version of financial regulatory reform on December 11, 2009, titled "The Wall Street Reform and Consumer Protection Act of 2009" (the "House Bill"). Both the Senate Bill and the House Bill contain a comprehensive set of financial regulatory reforms, including the Private Fund Investment Advisers Registration Act requiring mandatory registration with the SEC for most private fund investment advisers.

We note that, as of publication of this memorandum, the final text of the Senate Bill had not been released. Prior to being signed into law, the Senate Bill must be reconciled with the House Bill, a process which is expected to be completed in the coming weeks. Although it is generally expected that the bill that emerges from the reconciliation process will largely resemble the Senate Bill, there could be significant changes, including changes that impact investment adviser registration and regulation.

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 U.S. Investment Advisers Act of 1940, as amended (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).

Senate Bill v. House Bill. Both the Senate Bill and the House Bill would eliminate the "private adviser exemption" from registration with the SEC under the Advisers Act. Both versions would require most investment advisers 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. In each case, a "private fund" is defined as an issuer that would be an "investment company" under Section 3(a) of the U.S.

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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 and venture capital funds commonly rely on these provisions to avoid regulation as an investment company. The following chart outlines the key differences between the Senate's version and the House's version of the Private Fund Investment Advisers Registration Act.

SENATE BILL	HOUSE BILL
AUM Threshold for Mandatory SEC Registration:	
$100 million	$150 million[1]
Exemptions from Mandatory SEC Registration:	
Advisers to "venture capital funds" (to be defined by the SEC).	Same; however, venture capital funds would be subject to certain recordkeeping and reporting requirements.
Advisers that are "foreign private fund advisers," defined as an adviser that: (a) has no place of business in the U.S.; (b) has, in total, fewer than 15 clients who are domiciled in or residents of the U.S.; (c) has aggregate AUM attributable to clients and investors in the U.S. in private funds advised by such adviser of less than $25 million; and (d) neither holds itself out generally to the public in the U.S. as an investment adviser, nor acts as an investment adviser to any investment company registered under the Investment Company Act or any business development company.	Broadly the same; however, the House Bill looks through a fund to count the number of investors who are domiciled in or residents of the U.S. The House Bill also looks back over a period of 12 months for purposes of counting the number of investors and clients and determining aggregate AUM.
Advisers to small business investment companies, which are regulated by the Small Business Administration.	Same.
Advisers to "private equity funds" (to be defined by the SEC); however, such funds would be subject to certain recordkeeping and reporting requirements.	N/A
Excludes "family offices" (to be defined by the SEC in a manner consistent with the SEC's prior exemptive orders) from the definition of "investment adviser" under the Advisers Act, effectively placing such entities outside the purview of the Advisers Act.	N/A

[1] With respect to investment advisers to "mid-sized private funds" (not defined), the House Bill provides that the SEC shall provide for registration and examination procedures which reflect the level of systemic risk posed by such funds. In assessing systemic risk, the SEC must take into account the size, governance and investment strategy of such funds.

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SENATE BILL	HOUSE BILL
Record Keeping and/or Reporting Requirements:	
Records of any private fund advised by an SEC-registered adviser shall be "deemed to be the records and reports" of such investment adviser.	Same.
Advisers to private funds must maintain records and reports with respect to the following (such records are subject to SEC inspection and <u>may</u> be required to be filed with the SEC): • amount of AUM; • use of leverage; • counterparty credit risk exposures; • trading and investment positions; • valuation policies and practices of the fund; • types of assets held; • side arrangements or side letters; • trading practices; and • other information relevant to determining potential systemic risk.	Broadly the same, but the House Bill requires advisers to file reports with the SEC. Also, the House Bill does <u>not</u> require maintenance of records with respect to: • valuation policies and practices of the fund; • types of assets held; and • side arrangements or side letters.
The SEC is 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.	Same.
Information Sharing and Disclosures to Third-Parties:	
The SEC is permitted to share all reports and documents filed with it by an SEC-registered adviser with the Financial Services Oversight Council as necessary for the purposes of assessing the systemic risk of a private fund.	Broadly the same.
N/A	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.

SENATE BILL	HOUSE BILL
Protection of Proprietary Information:	
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.	Same.
Disclosure of Client Identity:	
The Senate Bill adds an additional exception to Section 210(c) of the Advisers Act which would permit the SEC to compel an investment adviser to disclose the identity, investments or affairs of its clients "for purposes of assessment of potential systemic risk."	The House Bill deletes Section 210(c) of the Advisers Act in its entirety which currently provides a prohibition limiting the SEC's ability to require investment advisers to disclose certain information about their clients.
Definition of Client:	
N/A	Prohibits the SEC from defining the term "client" to include an investor in a private fund.
Custody of Client Assets:	
Permits the SEC to promulgate rules to require an investment adviser to take steps to safeguard client assets over which it has custody, including verification of such assets by an independent public accountant.	N/A
Qualified Client Standard:	
N/A	The House Bill provides that the net worth and/or asset-based qualifications applicable to a "qualified client" under the Advisers Act shall be periodically adjusted for inflation by the SEC.
Effective Date:	
One-year after enactment of the legislation, during which time the SEC would be required to adopt rules and regulations providing procedures for registration, recordkeeping and reporting.	Same.

Regulation D Offerings. The Senate Bill also amends certain provisions of the U.S. Securities Act of 1933, as amended (the "Securities Act") applicable to private offerings made in reliance

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on the safe harbor set forth in Rule 506 of Regulation D of the Securities Act. The Senate Bill requires the SEC to issue rules disqualifying an offering or sale of securities as a Regulation D offering where the person offering the securities: (i) is subject to a final order by a state securities, banking or insurance authority, a federal banking agency or the National Credit Union Administration that (a) bars the person from (1) association with any entity regulated by such authority, (2) engaging in the business of securities, insurance or banking, or (3) engaging in savings association or credit union activities, or (b) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct within the 10-year period ending on the date of the filing of the Form D; or (ii) has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC. (This provision replaces an earlier provision that provided that if the SEC failed to review a private offering relying on Regulation D within 120 days, the offering would lose its covered securities status and would be subject to state review.)

Accredited Investor Standard. For purposes of the definition of "accredited investor" set forth in Rules 501(a) and 215 of the Securities Act, the Senate Bill would require the SEC to modify the net worth standard applicable to a natural person to provide that the value of a person's primary residence should be excluded from the $1 million net worth requirement. The SEC is required to review periodically such definition set forth in Rule 215 as it applies to natural persons and to modify the definition as it "may deem appropriate for the protection of investors, in the public interest, and in light of the economy." Interestingly, this provision fails to refer to the definition of "accredited investor" set forth in Rule 501(a) of the Securities Act for purposes of offerings made in reliance on Regulation D. It is unclear at this time whether this omission is intentional. In addition, within three years after enactment of the Senate Bill, the General Accountability Office would be required to submit a report to Congress on the appropriate criteria for accredited investor status and eligibility to invest in private funds.

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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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