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PRIVATE FUND REGULATION COMES INTO FOCUS: AN ANALYSIS OF THE PROPOSED PRIVATE FUND INVESTMENT ADVISERS REGISTRATION ACT OF 2009

On July 15, 2009, the U.S. Department of the Treasury (the "Treasury") released the Private Fund Investment Advisers Registration Act of 2009 (the "Advisers Registration Act").[1] The Advisers Registration Act would require federal registration of any U.S.-based investment adviser—including any private equity or hedge fund manager—that manages more than $30 million in assets. It would also subject those advisers and managers to increased scrutiny through new reporting requirements, amend in significant ways the Investment Advisers Act of 1940 (the "Advisers Act"), and grant new rulemaking authority to the U.S. Securities and Exchange Commission (the "SEC"). The Advisers Registration Act is the proposed legislation that arises from the Treasury's June 17, 2009, White Paper, *Financial Regulatory Reform; A New Foundation: Rebuilding Financial Supervision and Regulation* (the "White Paper").[2]

ELIMINATION OF THE PRIVATE ADVISER EXEMPTION

Most advisers to and managers of private funds have historically relied upon the "private adviser exemption" found in Section 203(b)(3) of the Advisers Act, which exempts from federal registration and regulation any investment adviser with less than 15 "clients" during the previous 12-month period and that does not hold itself out publicly as an investment adviser. Because a private fund has generally been counted as only one client for this purpose, many fund advisers and managers have utilized the private adviser exemption to avoid registration with the SEC. The

1 http://treas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf.

2 http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

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private adviser exemption would simply be eliminated for U.S.-based advisers and managers under the proposals set forth in the Advisers Registration Act. The resulting effect is that, with very few exceptions, any U.S.-based investment adviser with more than $30 million of assets under management will be required to register with the SEC. Investment advisers with less assets under management would generally be required to register in the state in which they maintain their principal place of business.

The private adviser exemption would be preserved, however, for "foreign private advisers"—*i.e.* advisers who (i) have no place of business in the United States, (ii) have had fewer than 15 U.S. clients in the previous 12-month period, (iii) manage less than $25 million of assets attributable to U.S. clients, (iv) do not hold themselves out publicly in the United States as investment advisers, and (v) do not act as an investment adviser to an investment company registered under the Investment Company Act of 1940 (the "Investment Company Act"). Given the relatively modest asset threshold, most foreign advisers seeking any meaningful investment from U.S. persons may be required to register with the SEC.

The Advisers Registration Act would specifically require any investment adviser to or manager of a "private fund" with more than $30 million in assets under management to register with the SEC. A "private fund" would be any fund that is defined in Section 3 of the Investment Company Act, but is otherwise exempt from registration as an investment company under Sections 3(c)(1) or 3(c)(7) thereof, and is either organized under the laws of the United States (or any state) or has 10 percent or more of its outstanding securities owned by U.S. persons. Depending on the value of assets under management, place of organization, and investor composition, many hedge funds, private equity funds, venture capital funds, family offices, real estate funds, structured finance vehicles, and other large, unregistered pools of capital would be considered "private funds" under the Advisers Registration Act.

Advisers and managers exempt from SEC registration are spared a significant regulatory burden that can restrict both their investment strategies and the types of clients whom they may solicit. Once registered, however, advisers and managers would be required to file Form ADV with the SEC and deliver to prospective investors Form ADV (Part II or its equivalent) detailing their services and fees, types of clients, investment strategies, methods of analysis, conflicts of interest, other business activities, education, and business standards.

Registered advisers would also be subject to the provisions of the Advisers Act dealing with the prohibition on the assignment of advisory contracts, the advertisement of prior performance, insider trading restrictions, restrictions on principal and agency trades, cash solicitation requirements, resolutions of conflicts of interest, proxy voting rules, compliance policies and procedures, trade allocation policies, maintenance of books and records, and valuation policies

Some private fund advisers and managers may also see their fee arrangements affected by the Adviser Registration Act. Currently, a registered investment adviser may receive only performance-based compensation (*e.g.*, incentive allocations, carried interest, and other performance-based fees) from "qualified clients." Funds exempt from registration under Section 3(c)(7) of the Investment Company Act are restricted to "qualified purchasers," and managers of those funds would remain free to charge performance-based compensation—even if they were required to register with the SEC. Funds exempt from registration under Section 3(c)(1) of the Investment Company Act, however, are not restricted to "qualified clients." If required to register under the Advisers Registration Act, these advisers and managers would be prohibited from receiving performance-based compensation from investors in Section 3(c)(1) funds who are not "qualified clients."

Finally, the Advisers Registration Act would eliminate Section 210(c) of the Advisers Act, which currently prohibits the SEC from compelling advisers to disclose the "identity, investments, or affairs of [their] clients, except insofar as such disclosure may be necessary or appropriate in a particular proceeding or investigation." The removal of this prohibition could potentially be the source of competitive harm to advisers and fund managers and could result in an invasion of investor privacy.

DISCLOSURE, REPORTING, AND EXAMINATION

In addition to the information currently required by the Advisers Act, the Advisers Registration Act would authorize the SEC to require registered investment advisers and managers to "maintain such records of and submit to the [SEC] such reports…as are necessary or appropriate in the public interest and for the assessment of systematic risk by the Board of Governors of the Federal Reserve System…." This information includes:

- Assets under management.
- Use of leverage (including the use of off-balance-sheet leverage and derivatives).
- Counterparty credit risk exposures.
- Investment positions.
- Trading practices.
- "Such other information as the [SEC]…determines necessary or appropriate in the public interest and for the protection of investors or for the assessment of systematic risk."

Registered advisers and managers would be required to keep records of this information and allow the SEC to inspect those records periodically or any other time that the SEC believes the behavior of a particular private fund poses a risk to financial markets.

These disclosure requirements raise significant concerns. Private funds use proprietary information and investment strategies to gain a competitive advantage in the marketplace. Disclosure of that information could certainly lead to competitive disadvantages. The SEC would be permitted to share that sensitive information with the Federal Reserve in order to assess any possible "systematic risk" posed by a fund's investment strategies. As funds disclose more information to more reviewers, the chances of inadvertent disclosure might also increase.

ENHANCED SEC RULEMAKING AUTHORITY

The Advisers Registration Act would also give the SEC broad authority to interpret terms used throughout the Advisers Act. The Advisers Registration Act specifically mentions the word "client" when discussing this enhanced authority. This appears to be a further attempt to eliminate the "private adviser exemption" under Section 203(b)(3) of the Advisers Act. In 2004, the SEC enacted the Hedge Fund Adviser Registration Rule (the "Fund Adviser Rule"), which required U.S. advisers with 15 or more clients in the preceding 12-month period to register under the Advisers Act. Instead of counting each fund as one "client," as had been the case for many years, the Fund Adviser Rule "looked-through" private funds and counted each investor in a fund as a "client" for purposes of registration under the Advisers Act. The Fund Adviser Rule was overturned by the District of Columbia Circuit Court in 2006.[3] Although perhaps not necessary given the other provisions of the Advisers Registration Act requiring the registration of advisers to and managers of private funds, the SEC would be given extensive discretion to interpret the meaning of "client," along with many other terms.

GOING FORWARD

While the Advisers Registration Act has received much of the recent attention, there are other legislative proposals and initiatives still under consideration by the Treasury, Congress, and the SEC. These include: the Private Fund Transparency Act of 2009,[4] which has the same general intent as the Advisers Registration Act, but without specifics; the Hedge Fund Adviser Registration Act of 2009,[5] which would strike the private adviser exemption and subject fund managers to the same regulatory burdens as advisers already registered with the SEC; and the Hedge Fund Transparency Act,[6] introduced in January 2009, which targets private funds more directly. On the notion that private funds have played an outsized role in the current financial crisis, the Hedge Fund Transparency Act proposes that private funds should disclose a substantial amount of their investors' personal information, including, among other things: (i) the names and addresses of investors in the fund, (ii) the

3 *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

4 http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s1276is.txt.pdf.

5 http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h711ih.txt.pdf.

6 http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s344is.txt.pdf.

primary accountants and prime brokers used by the fund; (iii) a statement of any minimum investment commitment required of an investor in the fund, and (iv) an explanation of the ownership structure of the fund. Lastly, in recent Congressional testimony,[7] the SEC indicated that fund registration is still under consideration.

The Advisers Registration Act will almost certainly undergo revision as it moves through various Congressional committees and toward possible enactment. The SEC, the Commodity Futures Trading Commission, and the Federal Reserve will have six months after the passage of the Advisers Registration Act to promulgate rules regarding the form and content of the reports required to be filed by registered investment advisers and managers. Although we may not know the particulars of the new regulatory scheme for some time, investment advisers, private fund managers, and perhaps private funds themselves are likely to see some form of enhanced registration and disclosure requirements by the beginning of 2010.

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7 http://www.sec.gov/news/testimony/2009/ts071509ajd.htm.

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