

# ClientAlert

## Investment Funds

November 2009

### Private Fund Investment Adviser Registration Bills Progressing Through Both Houses Of Congress



Proposed legislation seeking to change the regulatory paradigm for the financial industry continues to be produced as fast as the US Congress can work. The efforts reveal how much work legislators have ahead of them to harmonize the proposals. In addition, the push to get new laws passed has resulted in a big, collective “punt” of many important decisions to the regulatory agencies that will be responsible for enforcement of the new laws. This abdication of authority by Congress will therefore put regulatory authorities, including the US Securities and Exchange Commission (the SEC), in charge of making the laws that they will be enforcing, rather than merely defining the rules of engagement.

The various proposals to amend the Investment Advisers Act of 1940, as amended (the Advisers Act), provide ample evidence of both the broad scope of authority that is proposed to be granted to the SEC, as well as the many unanswered concerns that remain.

This Alert describes the major features of the two leading proposals in each house of Congress and compares the changes to the Advisers Act proposed by the Administration Proposal and the Bills. We have also provided a table at the end of this Alert summarizing and comparing the most significant features of these proposed new laws.

#### Legislative proposals

On July 15, 2009, as part of the financial regulatory reform package proposed by the Obama administration (the Administration), the US Treasury (the Treasury) introduced the Private Fund Investment Advisers Registration Act of 2009 (the Administration Proposal), seeking to enhance the regulation of private investment fund managers. This bill would require investment advisers to private funds to register with, and make reports to, the SEC under the Advisers Act.

On October 27, 2009, the Financial Services Committee of the US House of Representatives marked up and voted 67-1 to approve an amended version of the Administration Proposal that was introduced by the committee’s ranking member, Rep. Paul Kanjorski (D-PA) (as amended, the House Bill). On November 10, Sen. Christopher Dodd (D-CT), chairman of the US Senate Banking Committee, introduced to that committee a massive draft bill (the Senate Draft and, with the House Bill, the Bills) that addresses all of the legislative reforms proposed by the Administration, and then some. Title IV of the Senate Draft contains amendments to the Advisers Act and includes certain variations from both the House Bill and the Administration Proposal.

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The Senate Draft appears to have been drafted without consulting the House Bill or the discussion draft that preceded it, as it borrows none of the revisions made to the Administration Proposal by members of the Financial Services Committee. In addition to new concepts introduced by the Bills as compared to the Administration Proposal, the Bills offer many similar changes to aspects of the Administration Proposal. After the Senate Draft was unveiled, Financial Services Committee Chairman Barney Frank commented that “[o]bviously the bills aren’t going to be identical, but it confirms that we are moving in the same direction and reaffirms my confidence that we are going to be able to get an appropriate, effective reform package passed very soon.”

### Exemption for certain investment advisers

The Administration Proposal was criticized for taking a “one-size-fits-all” approach to regulation and imposing unnecessary costs on private funds and their sponsors that pose little systemic risk. In addition, critics cited the SEC’s failure to detect Bernard Madoff’s massive fraud despite his being a registered investment adviser, and expressed concern that requiring the SEC to oversee smaller funds would spread its limited resources too thin, diverting its attention from the real sources of risk. Both houses of Congress have sought to address these concerns in the Bills.

Both Bills introduce an exemption from registration for investment advisers to “venture capital funds” (as such term is to be defined by the SEC); the Senate Draft also exempts such advisers from any reporting requirements. The Senate Draft additionally exempts investment advisers to “private equity funds” (as such term is to be defined by the SEC) from its registration requirements.

Both houses of Congress support an enlargement and shift of the scope of regulatory responsibility over smaller investment advisers from the SEC to state securities regulators. The Senate Draft takes the relatively simple approach of increasing the eligibility threshold for federal registration for funds regulated or required to be regulated by a state from US\$25 million in total assets under management (AUM) to US\$100 million. This would likely force registered domestic investment advisers (including those who registered voluntarily) with between US\$25 million and US\$100 million in AUM to register with a state instead. The risk is that these advisers will now be subject to the uncertainty of an enforcement regime headed by possibly much less experienced regulators.

On the other hand, the House Bill provides that investment advisers to private funds that have AUM in the US of less than US\$150 million *each* would be exempt from registration. The

House Bill further provides that, in prescribing regulations to carry out the Adviser Act’s registration requirements with respect to investment advisers to “mid-sized private funds,” the SEC will consider such funds’ size, governance and investment strategy in determining the systemic risk that they may pose, and will provide for registration and examination procedures that reflect that level of risk. The House Bill does not define “mid-sized private funds” and directs the SEC to do so within six months of the enactment of the House Bill. The SEC is highly unlikely to define “mid-sized private funds” to include funds larger than US\$150 million.<sup>1</sup> Since the House Bill already proposes to leave the regulation of managers of funds of less than US\$150 million to the states, the actual effect of this additional provision is unclear.

By comparison, under another bill approved concurrently with the House Bill by the Financial Services Committee, the Investor Protection Act of 2009 (H.R. 3817) (the IPA), state regulators would be granted the authority to require registration of investment advisers with US\$100 million or more of AUM, but the SEC would maintain its authority to require concurrent registration or reporting. The IPA thus would provide the SEC the flexibility to decide the appropriate threshold for ceding regulatory oversight to the states over investment advisers generally.

While there are good reasons for limiting registration to only the largest advisers, examining AUM per fund can yield absurd results. For example, an investment manager that has 20 funds under management, each with US AUM of US\$149 million, would be exempt from registration. On the other hand, a manager with a single US\$200 million managed account and no other clients would not be. The regulatory inconsistency and the ease with which this provision can be circumvented leads us to believe this provision is unlikely to survive.

Finally, the House Bill adds an exemption from registration and any reporting requirements for investment advisers who solely advise “Small Business Investment Companies” licensed under the Small Business Investment Act of 1958 from registration, and the Senate Draft adds an exemption for “family offices” (as such terms is to be defined by the SEC) from the definition of “investment adviser.”

### Treatment of foreign advisers

The House Bill adopts the Administration Proposal’s exemption for “Foreign Private [Fund] Advisers,” which are defined as investment advisers who each (a) have no place of business in the US, (b) during the preceding 12 months have had (i) less than 15 clients in the US and (ii) assets under management attributable to clients in the US of less than US\$25 million (or such higher

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<sup>1</sup> By comparison, the version of the IPA that the House Financial Services Committee approved refers to investment advisers with US\$25 million to US\$100 million in total AUM (or higher, if the SEC deems appropriate) as “mid-sized investment advisers.”

amount as the SEC deems appropriate), and (c) neither hold themselves out generally to the public in the US as investment advisers, nor act as investment advisers to any investment company registered under the Investment Company Act of 1940, as amended (the Investment Company Act) or a company that has elected to be a business development company under the Investment Company Act. The Senate Draft offers a nearly identical exemption with one significant change: it omits the “during the preceding 12 months” language, using present tense throughout the test.

Under both Bills, the SEC would have the power to ascribe different meanings to terms used in the Advisers Act, including the term “client.” The House Bill, however, specifically excludes from such definition an investor in a private fund. As such, the House Bill would specifically preclude the SEC from interpreting the term “client” to include the underlying investors of a private fund as it has previously attempted to do. This specific carve-out to the SEC’s authority, if it survives in the bill as enacted, should provide foreign private fund advisers with comfort that the SEC will not deprive them of the exemption that the House Bill currently proposes to provide them, provided that they do not manage any US funds or managed accounts for US persons which have US\$25 million or more in assets under management.<sup>2</sup>

### Limited intrastate exemption

Currently, an investment adviser may rely on an exemption from registration under Advisers Act Section 203(b)(1) if all its clients are residents of the state within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities exchange-listed or admitted securities (the Intrastate Exemption). The Administration Proposal and both Bills include an exclusion from the Intrastate Exemption for any “investment adviser who acts as an investment adviser to any private fund.” In other words, an adviser to a private fund (as defined by the Bills) would no longer have the Intrastate Exemption available to it.

The Administration Proposal and Senate Draft define “private fund” as a fund that (a) would be an investment company under the Investment Company Act of 1940 but for the exception provided by either section 3(c)(1) or 3(c)(7) of that act and (b) either was organized under United States or state law or has 10 percent or more of its securities by value owned by US persons. The effect

of the second prong of the test is that the intrastate exemption would be withheld only from private fund advisers who manage funds organized under US law or with significant US investors. It would remain available to advisers who solely manage foreign funds with mainly foreign investors. The House Bill omits the second prong of the test.

### Recordkeeping, reporting and examinations

Under both Bills, registered advisers would be required to maintain such books and records and to submit such reports to the SEC regarding the adviser and the private funds they advise as are necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. Both Bills provide that the SEC will share such information with the governmental systemic risk regulatory body (the Systemic Risk Regulator). However, the House Bill identifies such body as the Board of Governors of the Federal Reserve System, or such entity that the SEC determines as having systemic risk responsibility. The Senate Draft directs that such information be provided to the Agency for Financial Stability, a new governmental unit that the Senate Draft contemplates would be in charge of assessing systemic risk.

Under both Bills, such information would include the adviser’s AUM; the use of leverage; counterparty credit risk exposure; trading and investment positions; and trading practices. The Senate Draft goes further by requiring that investment advisers disclose the underlying funds’ valuation methodologies; the types of assets held; and any side arrangements or letters providing certain investors with more favorable treatment or additional rights. The House Bill gives the SEC the option of requiring any additional information from particular advisers or advisors to certain types of funds that it deems necessary, taking into account the public interest and such advisor’s systemic risk potential.

Under both Bills, the SEC would share, on a confidential basis, copies of all information provided to the SEC by a registered adviser with the Systemic Risk Regulator. The House Bill provides that the SEC would additionally be authorized to require registered private fund advisers to provide certain reports, records and other documents to investors, prospective investors, counterparties and creditors of any private fund advised that are necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. Such required disclosures

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<sup>2</sup> By way of background, the SEC issued a rule in 2004 that defined the term “client” for purposes of counting clients toward the 14-client exemption from registration to include the underlying investors of hedge funds (i.e., private funds that permit owners to redeem any portion of their interests in such private fund within two years of the purchase of such interests). The effect of the rule was that advisers to hedge funds were required to register under the Advisers Act until the *Goldstein v. SEC* decision in 2006, in which the Federal Circuit held that the SEC did not have the authority to issue such a rule. The above provision in the discussion draft was seemingly specifically included to preempt *Goldstein*, thus arguably providing the SEC with an alternate path to mandatory private fund manager registration other than the one provided by the Advisers Act’s other provisions. The provision in the House Bill discussed above seems to preclude that. It is unclear, if the provision is included in the final bill, whether the provision will have any remaining practical effect.

to third parties raise concerns about the confidentiality of sensitive proprietary information, which will hopefully be dispelled by the removal or clarification of this provision before or when the two Bills are reconciled.

Both Bills provide that registered advisers would be subject at any time to periodic, special and other examinations by the SEC. In addition, investment advisers relying on the venture capital fund exemption or the exemption for less than US\$150 million in US AUM per fund in the House Bill, or the private equity fund exemption under the Senate Draft, would nonetheless be required to maintain such records and provide to the SEC such annual reports or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

### Other provisions

The Senate Draft also includes these additional provisions:

- Requires registered investment advisers to use independent custodians to hold client assets, giving the SEC authority to make appropriate exceptions.
- Provides that the accredited investor standard under the Securities Act of 1933 will be adjusted upward in light of price inflation since the threshold was originally determined, and then readjusted every five years.
- Provides that the Comptroller General will conduct a study to determine—
  - The appropriateness of the financial thresholds or other criteria needed to qualify for accredited investor status and to be eligible to invest in hedge funds.
  - The feasibility of forming a self-regulatory organization to oversee hedge funds, private equity funds and venture capital funds.
  - The state of short selling in the stock market.

The House Bill also includes these additional provisions:

- Provides for a one-year implementation period, but also gives investment advisers that would be required to register under the Advisers Act the option to register earlier.
- Provides that the Government Accountability Office will conduct a study to determine the costs of registration and reporting under the Advisers Act.
- Provides that any tests under the Advisers Act that prescribe a dollar amount will be adjusted for inflation within the first year of the House Bill's enactment and every five years thereafter.

### Next steps

As the reader can tell from the analysis of the legislative proposals, significant debate in Congress remains before passage of legislation that changes the regulatory regime for investment advisers, though change is definitely coming. Therefore, investment advisers should be asking themselves and their counsel the following questions:

- What are the benefits of seeking to avoid registration? There seem to be few avenues available left to avoid registration for the vast majority of investment fund managers, certainly hedge fund managers, and registration avoidance may be perceived negatively by the investor community. It is possible that private equity fund managers may end up being exempt from registration. Nevertheless, it is appropriate at this time for private equity fund managers to consider the possible implications of the proposed legislation on their operations.
- What systems must be put in place to achieve compliance with the new regime? Compliance with the Advisers Act has presented fewer challenges for clients than registration under different regimes, such as broker-dealer registration. Nevertheless, a chief compliance officer needs to be selected and educated, personnel need to be educated, compliance manuals need to be prepared and forms of reporting considered.
- For non-US investment advisers, what challenges are posed by the possibility of dual registration—in the adviser's home jurisdiction and in the US—and what kind of relief may be available for these advisers as the SEC discusses harmonizing the US regulatory regime with regulators in the European Union and different countries in Asia?
- Also for non-US investment advisers, how can they reconfigure their operations to avoid the issue of dual registration, as discussed above? What will be the competitive consequence of altering their operations to avoid US registration?

We believe that planning to meet the new regulatory regimes in the US and other jurisdictions, most notably the EU, will occupy a substantial portion of investment managers' time in early 2010. The sooner that the regulatory changes become clear and the sooner planning for compliance can take place and be completed, the better for investment managers so that they can stay focused on the business of making money for their clients.

## Summary

The table below summarizes the significant provisions in both Bills compared to those in the Administration Proposal.

	Administration Proposal	House Bill	Senate Draft
<b>Definition of "private fund"</b>	Funds that: (a) would be investment companies under the Investment Company Act of 1940 but for the exception provided by either section 3(c)(1) or 3(c)(7) of that act and (b) either (i) were organized under United States or state law or (ii) have 10 percent or more of their securities by value owned by US persons	Funds that would be investment companies under the Investment Company Act of 1940 but for the exception provided by either section 3(c)(1) or 3(c)(7) of that act	Same as Administration Proposal
<b>Exemptions from registration</b>	None	<ul style="list-style-type: none"> <li>■ Advisers to venture capital funds</li> <li>■ Foreign private advisers (12-month test)</li> <li>■ Advisers to registered Small Business Investment Companies<sup>3</sup></li> <li>■ Advisers solely managing funds with less than \$150 million in US AUM per fund</li> </ul>	<ul style="list-style-type: none"> <li>■ Advisers to venture capital funds<sup>3</sup></li> <li>■ Foreign private advisers (present-time test)</li> <li>■ Advisers to private equity funds</li> <li>■ Advisers registered or required to be registered in a US state with less than \$100 million in total AUM</li> <li>■ Family offices<sup>4</sup></li> </ul>
<b>Definition of terms, including the term "client"</b>	SEC has the authority to define terms to effectuate purpose of title	Same as Administration Proposal, but definition of "client" cannot include an investor in a private fund	Same as Administration Proposal
<b>Mandatory confidential reporting to SEC<sup>5</sup></b>	<ul style="list-style-type: none"> <li>■ AUM</li> <li>■ Use of leverage</li> <li>■ Counterparty credit risk exposure</li> <li>■ Trading and investment positions</li> <li>■ Trading practices</li> </ul>	Substantially the same as Administration Proposal	Substantially the same as Administration Proposal, plus: <ul style="list-style-type: none"> <li>■ Underlying funds' valuation methods</li> <li>■ Types of assets held</li> <li>■ Side letters</li> </ul>
<b>Optional confidential reporting to SEC</b>	Such information as SEC, in consultation with Systemic Risk Regulator, deems necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk	Substantially the same as Administration Proposal; can impose different requirements based on type or size of funds advised	Same as Administration Proposal
<b>Disclosure to third parties</b>	SEC could require disclosure to investors, prospective investors, counterparties and creditors of underlying fund information as necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk	Same as Administration Proposal	None
<b>Additional provisions</b>	None	<ul style="list-style-type: none"> <li>■ One-year implementation period, with early registration option</li> <li>■ Periodic inflationary adjustment of any monetary tests in Advisers Act</li> <li>■ Commission of study to determine cost of compliance</li> </ul>	<ul style="list-style-type: none"> <li>■ Independent custody of client assets</li> <li>■ Retroactive and subsequent periodic inflationary adjustment of accredited investor standard</li> <li>■ Commission of studies to examine financial threshold for accredited investor status and eligibility to invest in hedge funds; feasibility of SRO to oversee private funds; state of short-selling markets</li> </ul>

<sup>3</sup> Also exempt from reporting

<sup>4</sup> Exempt from definition of "investment adviser"

<sup>5</sup> To be shared with Systemic Risk Regulator

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