The Private Fund Investment Advisers Registration Act of 2009

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On July 15, 2009, the U.S. Treasury Department proposed new legislation that would amend the Investment Advisers Act of 1940 (the "Advisers Act") to require investment advisers to private investment funds (including hedge funds, private equity funds, and venture capital funds) to register with the U.S. Securities and Exchange Commission (the "SEC"). This proposed legislation, entitled the Private Fund Investment Advisers Registration Act of 2009[1] (the "Private Fund Adviser Registration Act"), seeks to increase transparency in the capital markets by allowing the federal government to monitor the activity of certain private investment funds and assess whether risks in a private fund (or risks aggregated across the private fund industry) pose a threat to the overall financial stability of the capital markets.

OVERVIEW:

While some advisers to hedge funds and other private investment funds are required to register with the Commodity Futures Trading Commission ("CFTC"), and some register voluntarily with the SEC, current law generally does not require private fund advisers to register with any federal financial regulator. Consequently, at present the SEC has only limited oversight authority over private fund advisers. In light of this limited oversight and the regulatory weakness exposed by the recent turmoil in the capital markets, it is the Obama Administration's view that securities laws have not kept pace with the growth and market significance of hedge funds and other private funds. Consequently, the Obama Administration is proposing to amend the Advisers Act in order to provide increased transparency with respect to certain private fund advisers.

If voted into law as proposed, the Private Fund Adviser Registration Act would require that most unregistered investment advisers with more than $30 million of assets under management (including private equity, venture capital, and hedge fund managers) to register with the SEC. The proposed legislation seeks to accomplish its goal by: (1) eliminating the private adviser exemption from the Advisers Act, (2) defining the term "private fund" broadly, (3) providing a narrow exemption for foreign advisers, (4) requiring advisers to maintain records and provide reports concerning their private funds, and (5) expanding the SEC's rulemaking authority.

PROPOSED AMENDMENTS:

1. Elimination of the Private Adviser Exemption

Under Section 203(b)(3) of the Advisers Act as currently enacted, an investment adviser is exempt from registration if during the preceding 12 months the adviser:

(a) has fewer than 15 clients (each fund constitutes one client), and

(b) does not:

(i) hold itself out generally to the public as an investment adviser, or

[1] The full text of the Private Fund Investment Advisers Registration Act of 2009 is available on the U.S. Department of the Treasury's website at http://www.ustreas.gov/press/releases/tg214.htm.

(ii) act as an investment adviser to a registered investment company or a company which has elected to be a business development company under the Investment Company Act of 1940 (the "1940 Act").

This is commonly referred to as the "private adviser" exemption. The Private Fund Adviser Registration Act seeks to eliminate this exemption and require all investment advisers to private funds with more than $30 million of assets under management to register with the SEC. Moreover, due to the breadth of the proposed language, any investment adviser with an office in the U.S. and more than $30 million in assets under management would potentially need to register with the SEC regardless of how many clients it has or whether it advises any funds (unless it can take advantage of a different exemption from registration).

2. Definition of Private Fund

The Private Fund Adviser Registration Act defines the term "private fund" as an investment fund that:

(a) would be required to register with the SEC as an investment company but for section 3(c)(1) or 3(c)(7) of the 1940 Act (i.e. the exemptions commonly relied upon by hedge funds to avoid registration under the 1940 Act); and

(b) either:

(i) is organized under the laws of the U.S. or a state, or

(ii) has 10 percent or more of its outstanding securities owned by U.S. persons.

According to these changes, unregistered advisers that manage funds that rely on the section 3(c)(1) or 3(c)(7) exemptions would be required to register under the proposed legislation. Furthermore, such a definition seems to be fairly broad, encompassing vehicles that are not typically thought of as hedge funds, such as structured finance vehicles that rely on section 3(c)(7). By utilizing this definition of private fund, the proposed legislation increases the number of potential advisers subject to registration and routine SEC examination. This will require private fund advisers to develop and maintain more robust compliance structures adequate to comply with the Advisers Act and the rules there under.

3. Foreign Private Adviser Exemption

The Private Fund Adviser Registration Act does provide an exemption from registration for any investment adviser that is a "foreign private adviser". A foreign private adviser is defined as an investment adviser who:

(a) has no place of business in the U.S.;

(b) during the preceding 12 months has had fewer than 15 clients in the U.S. and assets under management attributable to clients in the U.S. of less than $25 million, or such higher amount as the SEC may determine; and

(c) neither holds itself out generally to the public in the U.S. as an investment adviser nor acts as an investment adviser to a registered investment company or a company which has elected to be a business development company under the 1940 Act.

This exemption seems to be drawn quite narrowly. Pursuant to the clear language of the exemption, foreign advisers that manage only foreign funds would have to register even if they maintain only a

small office in the U.S. One issue that remains open is that the proposed legislation in unclear on whether a foreign adviser is required to include U.S. investors in non-U.S. funds towards the 15 client or $25 million assets under management limits.

4. Recordkeeping, Reporting and Disclosure Requirements

In order to ensure that the SEC has appropriate oversight going forward over private funds, the Private Fund Adviser Registration Act would grant the SEC broad rulemaking authority to require registered advisers to maintain certain records and provide information regarding the private funds they manage to the SEC. In order to assess the systemic risk posed to the capital markets by the failure of private funds, the SEC would be authorized to share these records and reports with the Board of Governors of the Federal Reserve System and the Financial Services Oversight Council as is appropriate in the public interest. Such requirements under the proposed legislation would include:

a) Substantial regulatory reporting requirements with respect to the assets under management, use of leverage, off-balance sheet exposure of the advised private funds, trading and investment positions, and trading practices;

b) Recordkeeping requirements;

c) More robust SEC examination and enforcement authority; and

d) Disclosure requirements concerning materials provided to investors, creditors, and counterparties regarding their advised private funds.

5. SEC Authority to Define Client

The Private Fund Adviser Registration Act also seeks to expand the rulemaking authority of the SEC, providing that the SEC may ascribe different meanings to terms (including the word "client") used in different sections of the Advisers Act as the SEC determines necessary.   This would give the SEC the authority to effectively overrule the Goldstein v. SEC[2] case that barred the SEC from requiring investment advisers to treat investors in funds as "clients" for purposes of the Advisers Act.

CONCLUSION:

Should the Private Fund Adviser Registration Act be enacted, many investment advisers not currently registered and examined by the SEC will need to register with the SEC and will be subject to new recordkeeping, reporting, and disclosure requirements. Although many details of the proposed legislation still need to be considered, it is clear that any law that is ultimately adopted will change the legal landscape affecting advisers of private funds significantly.

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[2] Goldstein v. S.E.C., 451 F.3d 873 (D.C. Cir. 2006).