Client Advisory

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Financial Services

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Senate Passes Financial Regulation Bill Requiring SEC Registration for Hedge Fund Managers with $100 Million or More under Management

The Private Fund Investment Advisers Registration Act of 2010 (Act), passed by the U.S. Senate on May 20, would require hedge fund managers with assets under management of $100 million or more to register as investment advisers with the Securities and Exchange Commission (SEC). The Act contains exemptions from registration for "family offices" and for advisers to "private equity funds" and "venture capital funds," leaving all such terms to be defined by the SEC. The Act imposes the registration requirement by eliminating the so-called "small advisers" (or "private advisers") exemption currently available to advisers with fewer than 15 clients in the preceding 12 months who did not hold themselves out to the public as investment advisers. By repealing this exemption, the Act would subject all such advisers, and not just hedge fund managers, to registration with either the SEC or potentially a state or multiple states (depending upon applicable state exemptions). By raising the current $25 million threshold for SEC registration to $100 million, another effect of the Act would be to cause SEC-registered U.S. investment advisers with assets under management between these two levels to have to de-register and become regulated by the states.

The Act is part of the comprehensive Restoring American Financial Stability Act of 2010 (Senate Bill). A conference committee, to be comprised primarily of select members of the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs, will meet in June to reconcile the differences between the Senate Bill and the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173), which the House of Representatives passed in December 2009 (House Bill). The goal of the conference committee is to send a final bill to the President for signature before the July 4 recess.

This Advisory focuses on the important changes that the Act would make to the Investment Advisers Act of 1940 (Advisers Act). Although titled the same in both the Senate Bill and the House Bill, the Act is somewhat different in each bill, as summarized in the chart in Section II below. Both bills vest a significant amount of discretion with the SEC in promulgating rules to implement their provisions. Therefore, even after enactment (i.e., signature by the President), the full impact of the financial services regulatory reform legislation will not be known for some time.

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I. The Act

The central provisions of the Act as adopted with the Senate Bill are as follows:

- **Elimination of "Small/Private Investment Adviser" Exemption.** The Act eliminates the exemption from registration under Section 203(b)(3) of the Advisers Act for investment advisers who had fewer than 15 clients in the preceding 12 months and did not hold themselves out to the public as investment advisers. This exemption is commonly used by advisers to private investment funds.
- **"Private Fund" Definition.** The Act defines a "private fund" as an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (ICA), but for the exclusion in Section 3(c)(1) or 3(c)(7) of the ICA.
- **Increase in Minimum Assets for SEC Registration.** The Act raises the asset threshold for federal registration of U.S. investment advisers from $25 million to $100 million under management.
- **New Exemptions from SEC Registration.** The Act exempts from federal registration advisers to "venture capital funds," "private equity funds" and "family offices," with such terms to be defined by the SEC after enactment. The Act requires the SEC to promulgate rules defining "venture capital fund" and "private equity fund" within six months of enactment and defining "family office" consistent with previous SEC exemptive orders.
- **Creation of "Foreign Private Adviser" Exemption.** The Act would require SEC registration of foreign advisers absent an applicable exemption. The Act creates such an exemption for a "foreign private adviser" that: (1) has no place of business in the United States; (2) has fewer than 15 clients in total who are domiciled in or residents of the United States; (3) has aggregate assets under management attributable to U.S. clients and U.S. investors in "private funds" advised by the adviser of less than $25 million (or such higher amount as the SEC may deem appropriate); and (4) neither (i) holds itself out generally to the U.S. public as an investment adviser, nor (ii) acts as an investment adviser to any investment company registered under the ICA or a business development company under the ICA.
- **Private Fund Books and Records.** The Act requires advisers and the private funds they manage to maintain and file records and reports regarding such private funds, including descriptions of assets under management, use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies, types of assets held, side arrangements or side letters, trading practices and other information, with provisions for confidential treatment of such records and reports (see **Protection of Proprietary Information** below). The SEC is required to inspect the books and records of private funds maintained by an investment adviser, and must provide an annual report to Congress describing how the SEC has used the data collected to monitor the markets for the protection of investors and the integrity of the markets.
- **Client Information.** The Act modifies Section 210(c) of the Advisers Act by adding a further exception to the general rule that client information is confidential, which would enable the SEC to require the disclosure by SEC-registered investment advisers of client information "for purposes of assessment of potential systemic risk" (as well as in connection with enforcement proceedings and investigations).
- **Adjustments to Accredited Investor Standards.** The Act permits the SEC to increase by rule the current net worth thresholds for "accredited investors" under Rule 501 under the Securities Act of 1933 to account for inflation, and to adjust that standard for inflation at least every four years thereafter.
  - The net worth threshold will remain $1 million for four years following enactment of the bill, but excluding the value of the investor's primary residence.
  - After the initial four-year period, the SEC is required to increase the net worth threshold to an amount exceeding $1 million, excluding the value of the investor's primary residence.
  - The Act authorizes the SEC, upon enactment, to review the definition of the term "accredited investor," as applied to natural persons, and to promulgate rules adjusting the provisions of the definition that do not relate to the net worth threshold.

  - The Act also requires the SEC, four years after enactment and every four years thereafter, to review the definition of the term "accredited investor," as applied to natural persons, and authorizes the SEC to modify the definition "as appropriate for the protection of investors, in the public interest, and in light of the economy."
- **Custody of Client Assets.** The Act allows for the SEC in its discretion to promulgate rules to require advisers to take steps to safeguard client assets over which they have custody, including requiring verification by an independent public accountant.
- **Protection of Proprietary Information.** The Act enhances confidentiality protection with respect to proprietary information provided to the federal government by making information provided under the Act to the SEC not subject to the Freedom of Information Act (FOIA) and providing additional safeguards. The Act defines "proprietary information" to include: (i) sensitive, non-public information regarding the investment or trading strategies of the investment adviser; (ii) analytical or research methodologies; (iii) trading data; (iv) computer hardware or software containing intellectual property; and (v) any additional information that the SEC determines to be proprietary.
- **Elimination of Intra-State Advisers Exemption.** The Act eliminates the exemption from registration under Section 203(b)(1) for an intra-state adviser that manages a private fund.
- **Definition of "Client."** The Act prohibits the SEC from modifying the definition of the term "client" for purposes of Section 206(1) and 206(2) of the Advisers Act to include investors in a private fund. This in effect reflects adoption by Congress of the 2006 U.S. Court of Appeals decision in *Goldstein vs. SEC*.

Grace Period. The Act would become effective one year after enactment, although an adviser may choose to register with the SEC during the one-year transition period.

The Act also requires the SEC to conduct a study regarding the ways of improving investor access to information on investment advisers and broker-dealers as well as the feasibility of forming a self-regulatory organization to oversee private funds.

Among areas that the Act does not address is the interplay between state and federal law with respect to investment adviser registration. For example, many states have a registration exemption linked to Section 203(b)(3), which would then not have any effect given the elimination of the federal exemption. The consequence would be that more advisers who do not meet the $100 million asset threshold in the Act would be required to be registered with a state or potentially multiple states, depending upon where their clients are located.

As mentioned above, the Act is part of the larger Senate Bill, the Restoring American Financial Stability Act of 2010, which must now be reconciled with the House Bill that was passed in December. In addition to the Act, the Senate Bill, among other provisions:

- requires the SEC to conduct a study and promulgate rules regarding the standards of care for brokers, dealers, investments advisers and their associated persons for providing investment advice to retail customers;
- similar to the administration's proposal known as the "Volcker Rule," (1) prohibits banks from sponsoring or investing in private funds or private equity funds or from engaging in proprietary trading, and (2) requires certain non-bank financial institutions to set aside additional capital if they sponsor or invest in private funds or private equity funds or engage in proprietary trading;
- establishes a Financial Stability Oversight Council, whose duties include identifying risks to the financial stability of the United States that could arise from the material financial distress or failure of large, interconnected bank holding companies or non-bank financial companies, and responding to emerging threats to the stability of the U.S. financial markets;
- establishes procedures for the orderly liquidation of financial firms whose resolution under other applicable federal or state law would have serious adverse effects on financial stability in the United States;
- provides for the regulation of the over-the-counter derivatives markets;

- authorizes the Federal Reserve Board to exercise supervision over "financial market utilities," including derivatives clearing organizations and securities clearing agencies; and
- requires credit ratings to be assigned by a rating agency chosen by a new Credit Rating Agency Board rather than by the issuer of the security.

II. Comparison of the Act and the Companion Provisions under the House Bill

The chart below summarizes the major similarities and differences between the House and Senate versions of the Private Fund Investment Advisers Registration Act of 2010.

SUBJECT MATTER	HOUSE BILL	SENATE BILL
Effective Date; Transition Period	Becomes effective one year after enactment, although an adviser may choose to register with the SEC during this one-year transition period.	Same.
Elimination of "Small/Private Investment Adviser" Exemption	Eliminates the exemption from registration for an adviser with fewer than 15 clients in the preceding 12 months (including an adviser with a single client, such as a manager of a single private fund or single managed account).	Same.
Definition of Private Fund	Defines a "private fund" as an issuer that would be an investment company, as defined in Section 3 of the ICA, but for Section 3(c)(1) or 3(c)(7) of the ICA.	Same.
Change in Asset Threshold for Federal Registration	No provision.	Raises the asset threshold for federal registration of U.S. investment advisers from $25 million to $100 million under management (without regard to the type of client).
Exemption of and Reporting by Certain Private Fund Advisers	Exempts from registration any investment adviser who advises solely private funds, each of which has assets under management in the United States of less than $150 million. Such exempted investment advisers are still required to maintain certain records and provide to the SEC annual or other reports, as the SEC determines.	No provision.
Exemption of Venture Capital Fund Advisers, Private Equity Fund Advisers and Family Offices	Exempts from registration advisers to "venture capital funds," to be defined by the SEC. Such exempt advisers are still required to maintain records and provide to the SEC annual or other reports, as the SEC determines. No exemption for "family offices" or advisers to "private equity funds."	Exempts from registration (but not certain recordkeeping and reporting requirements) advisers to "private equity funds" and exempts from registration advisers to "venture capital funds." Exempts "family offices" from adviser registration. All terms are to be defined by the SEC.

SUBJECT MATTER	HOUSE BILL	SENATE BILL
Limited Exemption for Foreign Private Advisers	Exempts from registration a foreign private adviser that has (1) no place of business in the United States; (2) fewer than 15 U.S. clients; (3) less than $25 million under management attributable to U.S. clients and U.S. investors in private funds; and (4) that neither holds itself out to the U.S. public as an adviser nor serves as an adviser to a registered investment company.	Same.
Adjustment of Accredited Investor Standards for Inflation	No provision.	Instructs the SEC to increase the current accredited investor standard to account for inflation, and to adjust the standard for inflation at least every four years thereafter.
Records and Reports	Requires registered advisers to private funds and such funds to maintain and file records and reports of such additional information as the SEC determines necessary, with provisions for confidential treatment of such records and reports.	Same.
Specific Records	Requires advisers to private funds and such funds to maintain and file records and reports describing (1) the amount of assets under management; (2) the use of leverage (including off-balance sheet leverage); (3) counterparty credit risk exposures; (4) trading and investments positions; and (5) trading practices.	Same. In addition, requires descriptions of (1) valuation policies and practices; (2) types of assets held; and (3) side arrangements or side letters.
Disclosure of Client Information	Eliminates the disclosure provision under Section 210(c) of the Advisers Act (which currently provides that the SEC may not require any investment adviser to disclose client information, except as such disclosure may be necessary or appropriate in an enforcement proceeding or investigation).	Amends the disclosure provision under Section 210(c) of the Advisers Act by adding that the SEC may require any investment adviser to disclose client information "for purposes of assessing potential systemic risk," as well as in connection with enforcement proceedings and investigations.

SUBJECT MATTER	HOUSE BILL	SENATE BILL
Adjustments to Qualified Client Standard	Requires the SEC to adjust for the effects of inflation, not later than one year after enactment and every five years thereafter, any factor in the "qualified client" standards under Section 205 of the Advisers Act that uses a dollar amount test.	No provision.
Small Business Investment Company Exemption	Exempts from registration advisers who solely advise small business investment companies.	Same but carves out from this exemption advisers to business development companies regulated under the ICA.
Commodity Trading Advisor (CTA) Exemption	Removes exemption from SEC registration for a CTA if its primary business is acting as an investment adviser to a private fund.	No provision.
Limits Intrastate Exemption	Eliminates the exemption from registration for intra-state advisers that act as an investment adviser to any private fund.	Same.