Obama Administration Proposes The "Private Fund Investment Advisers Registration Act of 2009"

On July 15, 2009, the Obama Administration delivered proposed legislation entitled the "Private Fund Investment Advisers Registration Act of 2009" to Capitol Hill.[1] The proposed legislation would amend the Investment Advisers Act of 1940 (the "Advisers Act") to, among other things:

- add a new definition of "private fund" which would broadly cover investment companies relying on the so called "private investment company" exemptions under the Investment Company Act of 1940;[2]
- add a new definition of "foreign private adviser" which would cover investment advisers having no place of business in the United States, fewer than 15 clients in the United States and less than $25,000,000 in assets under management attributable to clients in the United States;
- eliminate the Advisers Act's registration exemption presently available to investment advisers having fewer than 15 clients and which do not advise registered investment companies;
- impose disclosure and recording keeping requirements on advisers to private funds; and
- clarify that the rulemaking authority of the Securities and Exchange Commission ("SEC") under the Advisers Act includes promulgating rules and regulations defining "technical, trade, and other terms" used in the Advisers Act, including the term "client."

I. Background

Under the Advisers Act and the rules thereunder, investment advisers providing advice with respect to investing in securities and having at least $30,000,000 in assets under management are required to register with the SEC.[3] An exemption from registration is provided in the case of "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under [the Investment Company Act], or a company which has elected to be a business development company pursuant to [the Investment Company Act] and has not withdrawn its election."[4]

Rule 203(b)(3)-1 permits an investment adviser to an investment fund exempt from registration under the Investment Company Act that provides advice based on the investment objectives of the fund to count that fund as one client. In 2004, the SEC adopted rules that would require an adviser to a "private fund" to count all

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1 *Registration of Advisers to Private Funds*, available at http://www.ustreas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf. (the "Proposal")

2 Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), are referred to in this memorandum as the "private investment company" exemptions.

3 Generally, investment advisers having at least $25,000,000 but less than $30,000,000 in assets under management may register with the SEC, or may simply choose to be subject to registration under applicable state investment adviser regulations as would be the case for advisers having less than $25,000,000 in assets under management. Investment advisers to registered investment companies must register under the Advisers Act. *See,* Advisers Act Rule 203A-1.

4 Advisers Act Section 203(b)(3).

investors in the private fund as clients for purposes of the "fewer than fifteen clients" test. This approach would trigger Advisers Act registration for advisers to private funds in any instance in which a private fund had fifteen or more investors.[5] The SEC attributed the need for such registration requirements to three primary factors:

- the increasing size of hedge funds;
- the increasing number of enforcement actions the SEC was bringing against hedge fund advisers; and
- the expansion of the group of investors in hedge funds to include a broader group of people than the wealthy and sophisticated investors that had traditionally invested in hedge funds.[6]

The SEC's 2004 rulemaking was struck down by the United States Court of Appeals for the District of Columbia Circuit in the 2006 decision *Goldstein v. S.E.C.*[7] The Court held that the SEC had not adequately explained how the relationship between hedge fund investors and advisers justified treating the former as clients of the latter and thus found the SEC's rulemaking to be arbitrary.

In the wake of the *Goldstein* decision, then SEC Chairman Christopher Cox stated that legislation might be necessary to "address the gaping hole that the *Goldstein* decision has left."[8] The Obama Administration's proposed legislation tries to serve this purpose by requiring the registration of advisers to private funds. This memorandum summarizes the requirements that the proposed legislation seeks to put in place.[9]

II. The Scope of the Proposed Legislation

The proposed legislation applies not only to hedge fund advisers, but also to other advisers of investment funds relying on the private investment company exemptions from registration under the Investment Company Act. This "includes managers to private equity and venture capital funds."[10] The proposed legislation defines a private fund as

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5 *Registration Under the Advisers Act of Certain Hedge Fund Advisers,* SEC Release No. IA-2333 (December 2, 2004), *available at* http://www.sec.gov/rules/final/ia-2333.htm, amending Advisers Act Rule 203(b)-1 and adopting Advisers Act Rule 203(b)(3)-2. "Private fund" was generally defined to mean a company which relies on one of the private investment company exemptions from registration under the Investment Company Act and which permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests.

6 *Id.*

7 451 F.3d 873 (D.C. Cir. 2006).

8 Christopher Cox, SEC Chairman, Testimony Concerning the Regulation of Hedge Funds before the U.S. Senate Committee on Banking, Housing and Urban Affairs (July 25, 2006), *available at* http://www.sec.gov/news/testimony/2006/ts072506cc.htm.

9 For a discussion of similar legislative proposals entitled the "Hedge Fund Transparency Act of 2009" and the "Hedge Fund Adviser Registration Act of 2009" see the Firm's earlier memoranda on those topics: "Registration of Private Investment Companies Proposed in Senate Bill" dated February 2, 2009, *available at* http://cgrnyvs1/Firm%20Memos/Registration%20of%20Private%20Investment%20Companies%20Proposed%20in%20Senate%20Bill.pdf; "Further Thoughts on Pending Private Fund Transparency Initiatives" dated February 11, 2009, *available at* http://cgrnyvs1/Firm%20Memos/Further%20Thoughts%20on%20Pending%20Private%20Fund%20Transparency%20Initiatives.pdf.

10 Bart Mallon, Esq., Treasury Announces New "Private Fund Investment Advisers Registration Act of 2009," (July 15, 2009), *available at* http://www.hedgefundlawblog.com/obama-moves-forward-with-hedge-fund-registration-legislation.html.

> "an investment fund that (A) would be an investment company (as defined in section 3 of the Investment Company Act), but for section 3(c)(1) or 3(c)(7) of the Investment Company Act; and (B) either (i) is organized or otherwise created under the laws of the United States or of a State; or (ii) has 10 percent or more of its outstanding securities owned by U.S. persons." [citations omitted][11]

The last clause of the proposed definition appears to be an attempt to bring investment advisers to offshore (non-U.S.) investment companies within the scope of the Advisers Act if the amount invested in them by U.S. investors meets the 10 percent threshold. However since offshore investment funds that privately offer their securities to United States investors do not rely on the private investment company exemptions to avoid being required to register under the Investment Company Act, it is not clear that the "but for language" in clause (A) of the above quoted provision would in fact cover investment advisers to such offshore funds.[12]

III. Elimination of Private Investment Adviser Exemption

The proposed legislation would eliminate the current "fewer than fifteen clients" exemption in Section 203(b)(3) of the Advisers Act, quoted above.[13] This exemption was added to the Advisers Act in 1970 and has been relied upon by countless investment advisers to private investment funds and eliminating it would affect many investment advisers to such funds. The text of Section 203(b)(3) as it would be amended is set forth on Annex A to this memorandum.

IV. Record Keeping Requirements

Registered investment advisers presently must comply with extensive record keeping requirements. The proposal adds to those requirements in two ways.

First, the proposal authorizes the imposition of record keeping requirements to assist in the broad oversight of the financial system proposed in the financial regulatory reform initiative launched by the Administration.[14] The SEC would be able to require registered investment advisers to "maintain such records of and submit to the Commission such reports regarding private funds advised by the investment adviser as are necessary or appropriate in the public interest and for the assessment of systemic risk by the Board of Governors of the Federal Reserve System and the Financial Services Oversight Council, and to provide or make available to the Board of Governors of the Federal Reserve System and the Financial Services Oversight Council those reports or records or the information contained therein."

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11 Proposal Section 402.

12 Offshore investment funds that offer their securities privately to United States investors typically rely on SEC no-action letters interpreting Section 7(d) of the Investment Company Act to avoid having to register under that statute. Those no-action letters apply the concepts underlying the private investment company exemptions by analogy but do not expressly apply either Section 3(c)(1) or 3(c)(7) of the Investment Company Act to offshore funds.

13 Proposal Section 403.

14 See CGR Memorandum "The Department of the Treasury Announces a New Foundation for Financial Regulatory Reform" dated June 24, 2009 *available at* http://cgrnyvs1/Firm%20Memos/The%20Department%20of%20the%20Treasury%20Announces%20a%20New%20Foundation%20for%20Financial%20Regulatory%20Reform.pdf

In addition, under the proposed legislation, the investment adviser would have to file with the SEC at a minimum, for each private fund advised by the investment adviser:

- the amount of assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading and investment positions, and trading practices; and
- "such other information as the Commission, in consultation with the Board of Governors of the Federal Reserve System, determines necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk."[15]

Registered investment advisers would be required to keep such records for as long as the SEC prescribes through its regulations. These records would be subject to examinations by the SEC from time to time, and the proposed legislation would require the investment adviser to make available "any copies or extracts from such records as may be prepared without undue effort, expense or delay as the Commission or its representatives may reasonably request." The SEC would also be required to make copies of records, reports, documents and other information provided to the SEC available to the Board of Governors of the Federal Reserve System and the Financial Services Oversight Council, as either of those bodies considers necessary.

Consistent with this new mandate, Section 210(c) of the Advisers Act, which currently restricts the ability of the SEC to share information with other agencies, would be stricken.[16]

V. Disclosures Concerning Private Funds to Investors and Others

The proposed legislation authorizes the SEC to promulgate rules and regulations requiring registered investment advisers to provide the required reports, records and other documents "to investors, prospective investors, counterparties, and creditors, of any private fund advised by the investment adviser."[17]

VI. Clarification of SEC Rulemaking Authority

Among other things it is clear that the proposed legislation is specifically designed to override the decision in *Goldstein*. In a section titled "Clarification of Rulemaking Authority" the proposal would make clear that the SEC had broad authority to promulgate rules under the Advisers Act

> ", including rules and regulations defining technical, trade, and other terms used in this title. For the purposes of its rules and regulations, the Commission may—
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> "(1) classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters; and
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> "(2) ascribe different meanings to terms (including the term 'client') used in different sections of this title as the Commission determines necessary to effect the purposes of this title[.]"[18]

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15 Proposal Section 404.

16 Proposal Section 405.

17 Proposal Section 404.

18 Proposal Section 406 amending Section 211 of the Advisers Act.

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It is important to emphasize that it is uncertain if the proposed legislation will be adopted in its current form and of course, the specifics of any SEC rulemaking under the legislation, if it is enacted, remain to be seen.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

ANNEX A

Section 203(b) of the Investment Advisers Act as it would be amended by proposed legislation:

(b) Investment advisers who need not be registered

The provisions of subsection (a) of this section shall not apply to—

(1) any investment adviser, except an investment adviser who acts as an investment adviser to any private fund, all of whose 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 listed or admitted to unlisted trading privileges on any national securities exchange;

(2) any investment adviser whose only clients are insurance companies;

(3) any investment adviser that is a foreign private adviser;

(4) any investment adviser that is a charitable organization, as defined in section 3(c)(10)(D) of the Investment Company Act of 1940 [15 U.S.C. 80a–3 (c)(10)(D)], or is a trustee, director, officer, employee, or volunteer of such a charitable organization acting within the scope of such person's employment or duties with such organization, whose advice, analyses, or reports are provided only to one or more of the following:

(a) any such charitable organization;

(b) a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940 [15 U.S.C. 80a–3 (c)(10)(B)]; or

(c) a trust or other donative instrument described in section 3(c)(10)(B) of the Investment Company Act of 1940 [15 U.S.C. 80a–3 (c)(10)(B)], or the trustees, administrators, settlors (or potential settlors), or beneficiaries of any such trust or other instrument;

(5) any plan described in section 414 (e) of title 26, any person or entity eligible to establish and maintain such a plan under title 26, or any trustee, director, officer, or employee of or volunteer for any such plan or person, if such person or entity, acting in such capacity, provides investment advice exclusively to, or with respect to, any plan, person, or entity or any company, account, or fund that is excluded from the definition of an investment company under section 3(c)(14) of the Investment Company Act of 1940 [15 U.S.C. 80a–3 (c)(14)]; or

(6) any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor whose business does not consist primarily of acting as an investment adviser, as defined in section 80b–2 (a)(11) of this title, and that does not act as an investment adviser to—

(a) an investment company registered under subchapter I of this chapter;

(b) a company which has elected to be a business development company pursuant to section 80a–53 of this title and has not withdrawn its election; or

(c) a private fund.