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Treasury Department Proposes Changes to Registration Requirements for Private Funds

On July 15, 2009, the U.S. Department of the Treasury proposed legislation titled "Private Fund Investment Advisers Registration Act of 2009." The proposed act (the "*Proposed Act*") would amend the Investment Advisers Act of 1940 (the "*Advisers Act*") to require any U.S.-based investment fund manager with more than $30 million in assets under management to register as an investment adviser with the U.S. Securities and Exchange Commission (the "*SEC*"). The Proposed Act relates to "private funds," which are defined as investment funds organized in the United States or which have 10% or more of its outstanding securities owned by U.S. persons and which are exempt from registration under the Investment Company Act of 1940 based on its having 100 or fewer investors or only investors who are qualified purchasers (i.e., very high net worth and institutional investors). As defined, private funds include virtually all private investment funds, including hedge funds, private equity funds, and venture capital funds. The Proposed Act would further require such managers of private funds to report to the SEC information about the funds they advise so that the SEC, in conjunction with the Federal Reserve and the Financial Services Oversight Counsel, may make assessments of the systemic risk proposed by the funds.

Current Law: The Advisers Act, in broad terms, defines an investment adviser as a person who advises others, either directly or through publications, with respect to investments in securities in return for compensation. An investment adviser is required to register with the SEC absent an exemption from registration. While all investment advisers are subject to the antifraud provisions of the Advisers Act whether they are required to be registered or not, registration under the Advisers Act creates significant compliance and reporting requirements. Investment advisers that are required to register under the Advisers Act are not permitted to charge performance-based fees to certain clients, are subject to many restrictions on advertising and client solicitations, and must comply with significant recordkeeping requirements.

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Investment fund managers of venture capital funds, private equity funds, hedge funds, and other private investment funds often rely on the "private adviser exemption" to avoid registration under the Advisers Act and the related compliance obligations. The private adviser exemption exempts any adviser who during the course of the preceding 12 months has had fewer than 15 "clients" and who neither holds himself out to the general public as an investment adviser nor acts as an adviser to a registered investment company (i.e., mutual funds and other publicly registered or large investment funds). For purposes of the determination of the number of clients that an investment fund manager has, each investment fund is considered one client and, therefore, unless a firm manages 15 or more funds, there is little concern with registration under the Advisers Act.

Proposed Changes: The Proposed Act would eliminate this private adviser exemption for all but certain foreign private advisers and would require all domestic advisers of private funds to register with the SEC if the investment adviser has more than $30 million under management. The Proposed Act also eliminates exemptions for private fund advisers operating and advising clients within a single state on securities not listed on a national exchange and for advisers registered with the Commodity Futures Trading Commission as commodity trading advisors.

In addition to the changes to the registration requirements, the Proposed Act would remove the provision of the Advisors Act that prohibits the government from requiring investment advisors to disclose the identity, investment, or affairs of any client (other than in connection with enforcement matters), and would grant the SEC the rulemaking authority to require registered investment advisers to submit to the SEC such reports about private funds "as are necessary or appropriate in the public interest for the assessment of systemic risk." These reports may include information on, among other things, the assets under management, use of leverage (including leverage accounted for off-balance sheet), exposure to counterparty credit risk, trading, and investment positions, and trading practices. The Proposed Act would authorize the SEC to collaborate with the Federal Reserve and the Financial Services Oversight Counsel to determine the content required in such reports and to share with them the reports so they jointly may assess any systemic risk posed by the funds. While the Proposed Act states that such reports would remain confidential, the reports would still be accessible by court order, by Congress, and by other federal departments acting within the scope of their jurisdiction.

The Proposed Act additionally requires investment advisers to provide reports, records, and documents to investors, prospective investors, counterparties, and creditors of the private funds they advise. The specific nature of these reports will be determined by rules later issued by the SEC.

Finally, the Proposed Act would explicitly allow the SEC to define terms in

the Advisers Act through its rulemaking authority. The SEC would be allowed to ascribe different meanings to terms used in different sections of the Advisers Act. As a result, the Proposed Act would legislatively reverse the 2006 decision by the U.S. Court of Appeals for the D.C. Circuit in *Goldstein v. SEC* (Click here to view our article about that case). The SEC would be able to interpret terms such as "client" in such a way as to further refine the regulation of advisers of certain types of funds or different classes of investors.

The Proposed Act is the latest piece of proposed legislation offering greater regulation of private funds generally. A virtually identical act, the "Private Fund Transparency Act of 2009," was introduced in the Senate by Senator Jack Reed (D-R.I.) on June 15, 2009. While this proposed legislation indicates a clear intention by the Obama Administration and Congress to increase regulation of private investment funds, the form of any final legislation is still highly uncertain.

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