



Private Fund Investment Advisers Registration Act of 2010

With the recent passage of comprehensive health care legislation, Congress has refocused its attention on the regulation of the United States financial markets. On March 22, 2010, the Senate Banking Committee approved the Restoring American Financial Stability Act of 2010 (the “**RAFSA**”), which was originally introduced by Senate Banking Committee Chairman Christopher Dodd (D-CT) on March 15, 2010. Included within the RAFSA is the Private Fund Investment Advisers Registration Act of 2010 (the “**Senate Bill**”), which is the latest in a series of legislation introduced by the Senate and the House of Representatives (the “**House**”) targeting the regulation of private investment funds, including hedge funds and private equity funds. We previously analyzed an earlier version of the Senate Bill in an O’Melveny & Myers Client Alert dated November 12, 2009[1].

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The approval of the Senate Bill by the Senate Banking Committee comes just months after the House approved the Wall Street Reform and Consumer Protection Act of 2009 (the “**Wall Street Reform Act**”) on December 11, 2009. The Wall Street Reform Act, which was introduced by House Financial Services Committee Chairman Barney Frank (D-MA), includes the Private Fund Investment Advisers Registration Act of 2009 (the “**House Bill**”), which is the House’s counterpart to the Senate Bill. We previously analyzed the House Bill in an O’Melveny & Myers Client Alert dated December 14, 2009 [2].

The Senate Bill will now proceed from the Senate Banking Committee to the full Senate for a vote, where it will be subject to further review and amendment. If approval is granted by the Senate, the House and the Senate would begin the process of reconciling the House Bill and the Senate Bill to provide for a uniform, comprehensive bill. Recent press reports indicate that financial reform legislation is a top priority for both Congress and the Obama administration. As a result, barring a Republican-led filibuster (which many observers regard as unlikely to be successful), we expect Congress to finalize legislation to further regulate the financial markets during 2010, and possibly as early as Memorial Day.

While the House Bill and Senate Bill contain certain conflicting provisions that must be reconciled, the consistent provisions suggest that the final legislation, if adopted, would have a significant impact on domestic and foreign advisers to private investment funds by (i) requiring certain unregistered advisers to register with the Securities and Exchange Commission (“**SEC**”) under the Investment Advisers Act of 1940, as amended (the “**Advisers Act**”), and (ii) imposing certain reporting, disclosure and record-keeping obligations on registered investment advisers (and potentially unregistered advisers). Most notably, each of the House Bill and the Senate Bill eliminates the “private adviser exemption,” which is the exemption from registration for advisers to private investment funds who have less than 15 clients during the preceding 12 months and do not hold themselves out to the public as an investment adviser. Many domestic and foreign advisers to private investment funds rely on the private adviser exemption to avoid registering under the Advisers Act.

Advisers to private funds should take note of the following conflicting provisions between the House Bill and the Senate Bill, as the reconciliation of these provisions will have a significant impact on whether certain advisers are required to register with the SEC:

1. **Exemption for Private Equity Funds and Venture Capital Funds:** The House Bill and the Senate Bill each provide for an exemption from registration for advisers to “venture capital funds.” However, only the Senate Bill provides an exemption from registration for advisers to “private equity funds,” although such private equity funds would be required to retain certain records and be subject to certain reporting obligations prescribed by the Senate Bill. Under each bill, the SEC would be tasked with defining the term “venture capital fund” and “private equity fund” and crafting the relevant exemption.

2. **Exemption for Foreign Private Advisers:** The Senate Bill provides an exemption from registration for “foreign private advisers” that (i) have no place of business in the U.S., (ii) do not generally hold themselves out to the public in the U.S., (iii) have fewer than 15 clients[3] in the U.S., and (iv) have less than \$25 million in assets under management that are attributable to clients in the U.S. and investors in the U.S. in private funds advised by the investment adviser. Consequently, a foreign investment adviser would not be required to register under the Senate Bill if (x) it advised less than a combined 15 private investment funds in the U.S. (regardless of whether the investment funds managed by the adviser include U.S. investors) and natural persons or entities in the U.S. who have a direct advisory relationship (e.g., through a managed account) with the adviser, and (y) less than \$25 million of assets under management were contributed by U.S. investors.

The House Bill slightly narrows the “foreign private adviser” exemption by requiring the adviser to have fewer than 15 clients and investors in the U.S. As a result, a foreign investment adviser would not be required to register under the Advisers Act if (i) it has less than a combined 15 U.S. investors in private investments funds and U.S. managed account clients, and (ii) less than \$25 million of assets under management were contributed by U.S. investors.

3. **Definition of “Client”:** The House Bill formally adopts the interpretation that the term “client” includes only persons or entities that have a direct advisory relationship with the adviser and prohibits the SEC from including the underlying investors of a private investment fund in the definition of “client” so long as such fund has entered into an advisory agreement with the adviser. Conversely, the Senate Bill provides the SEC with statutory authority to define the term client. If the Senate Bill is adopted in its current form, the SEC could potentially define “client” to include the underlying investors in a private investment fund, which would have a significant impact on a registered adviser with respect to, among other things, its fiduciary duties to clients, the cash solicitation rule (Rule 206(4)-3), and the custody rule (Rule 206(4)-2).

Please refer to the table below for a summary of select provisions of the House Bill and the Senate Bill and for highlights of the similarities and differences between the bills.

	House Bill December 11, 2009	Senate Bill March 22, 2010
Federal Registration Requirement:	Currently, many advisers to private funds[4] (including advisers or managers based outside of the U.S.) rely upon the private adviser exemption to avoid registering as an investment adviser with the SEC under the Advisers Act. In general, the private adviser exemption provides that an adviser with less than 15 clients during the preceding 12 months that does not hold itself out to the public is exempt from registration under the Advisers Act.	
Elimination of Private Adviser Exemption:	The private adviser exemption would be eliminated by removing <u>Section 203(b)(3)</u> of the Advisers Act in its entirety.	The private adviser exemption would be eliminated by removing <u>Section 203(b)(3)</u> of the Advisers Act in its entirety.
Exemption from Federal Registration: Venture Capital Funds	Advisers to “venture capital funds” would be exempted from the requirement to register, but the SEC would be tasked with defining the term “venture capital fund” and crafting the exemption.	Advisers to “venture capital funds” would be exempted from the requirement to register, but the SEC would be tasked with defining the term “venture capital fund” and crafting the exemption.
Exemption from Federal Registration: Private Equity Funds	The House Bill does not include a registration exemption for private equity funds.	Advisers to “private equity funds” would be exempted from the requirement to register, but the SEC would be tasked with defining the term “private equity fund” and crafting the exemption. The Senate Bill would however, require the SEC to issue final rules within six months requiring investment advisers to private equity funds to maintain such records and provide to the SEC such annual or other reports as the SEC determines necessary and appropriate in the public interest and for the protection of investors.
Exemption from Registration for Foreign Private Advisers:	The House Bill provides a limited exemption from registration for foreign investment advisers and greatly restricts their ability to solicit U.S. capital	The Senate Bill would exempt from registration “foreign private advisers”, defined as investment advisers that:

	<p>without being subject to registration. The House Bill would exempt from registration "foreign private advisers," defined as investment advisers that:</p> <ol style="list-style-type: none"> 1. have no place of business in the U.S.; 2. do not generally hold themselves out to the public in the U.S.; 3. have fewer than 15 clients <u>and</u> investors in the U.S. during the past 12 months; and 4. have less than \$25 million aggregate assets under management attributable to clients <u>and</u> investors in the U.S. in private funds during the past 12 months. <p>As a result, this exemption is slightly narrower than the one provided by the Senate Bill. A foreign investment adviser would be required to register under the Advisers Act if (i) it has a combined 15 U.S. managed accounts clients and U.S. investors in private funds, or (ii) if \$25 million of assets under management are attributable to U.S. investors.</p>	<ol style="list-style-type: none"> 1. have no place of business in the U.S.; 2. do not generally hold themselves out to the public in the U.S.; 3. have in total fewer than 15 clients in the U.S.; and 4. have less than \$25 million in assets under management that are attributable to clients in the U.S. and investors in the U.S. in private funds advised by the investment adviser. <p>As a result, a foreign adviser would be required to register if (i) it had 15 clients (e.g., managed accounts or pooled investment vehicles) in the U.S. or (ii) \$25 million of assets under management are attributable to U.S. investors</p>
<p>Exemption from Registration: Assets Under Management Threshold</p>	<p>Investment advisers with less than \$150 million in assets under management who solely provide advice to "private funds" are exempt from registration. Investment advisers who have direct advisory relationships with clients (e.g., through managed accounts) or have assets under management of \$150 million or more cannot rely on this exemption.</p>	<p>Investment advisers with less than \$100,000,000 of assets under management would not be subject to registration as an investment adviser with the SEC under the Senate Bill. The Senate Bill also raises the threshold for registration with the SEC to \$100 million from \$25 million.</p>
<p>Exemption from Federal Registration: Family Offices</p>	<p>The House Bill does not contain an exception from the definition of "investment adviser" in Section <u>202(a)(11)</u> for family offices.</p>	<p>Family offices would be exempt from the definition of "investment adviser" in Section <u>202(a)(11)</u>. The term "family office" would be defined by SEC rule.</p>
<p>Recordkeeping, Reporting, and Examinations:</p>	<p>The House Bill would require investment advisers to "private funds" to file certain information including, for each private fund, the assets under management, the use of leverage, counterparty credit risk exposure, and trading and investment positions, among other things.</p> <p>The House Bill would also provide the SEC with broad authority to require investment advisers to maintain records and to submit reports to the SEC to enable the SEC or another federal department or agency to supervise systemic risk. The SEC would be required to consult with the Board of Governors of the Federal Reserve System (the "Board") when determining what records an investment adviser to a private fund is required to maintain and the reports they are required to file.</p> <p>The House Bill would provide the SEC with broad authority to examine the records of both private funds and the advisers to such funds.</p> <p>The SEC would be required to share with the Board or any other federal agency having systemic risk responsibilities, copies of all reports, documents, records and information filed with the SEC. The SEC would keep such information confidential and, subject to certain limited</p>	<p>The Senate Bill would require investment advisers to "private funds" to file certain information including, for each private fund, the assets under management, the use of leverage, counterparty credit risk exposure, types of assets held, valuation methodologies of the fund, side arrangements or side letters, and trading and investment positions, among other things.</p> <p>The Senate Bill would also provide the SEC with broad authority to require investment advisers to maintain records and to submit reports to the SEC to enable the SEC or another federal department or agency to supervise systemic risk. The SEC would be required to consult with the Financial Stability Oversight Council (the "Council") when determining what records an investment adviser to a private fund is required to maintain and the reports they are required to file.</p> <p>The Senate Bill would provide the SEC with broad authority to examine the records of advisers to private funds and the records of such funds.</p> <p>The SEC would be required to share with the Council or any other federal agency having</p>

	<p>exceptions, could not be compelled to disclose it.</p> <p>Finally, the House Bill would authorize the SEC to require advisers to private funds to provide to investors, prospective investors, counterparties and creditors such information as the SEC deems necessary or appropriate in the public interest.</p>	<p>systemic risk responsibilities copies of all reports, documents, records and information filed with the SEC. The SEC would keep such information confidential and, subject to certain limited exceptions, could not be compelled to disclose it.</p>
<p>Rules and Regulations to be Based on Systemic Risk Profile:</p>	<p>The House Bill contains a provision that requires the SEC to take certain characteristics of private funds into account when prescribing rules and regulations pertaining to registration and examination procedures. Specifically, the SEC must take into account the size, governance, and investment strategies of "mid-sized funds" (this term is not defined in the House Bill) to determine whether they pose systemic risk, and tailor the registration and examination procedures applicable to their advisers accordingly.</p>	<p>The Senate Bill contains a provision that authorizes the Commission after consulting the Council to require registered advisers to maintain, any information regarding private funds advised by the investment adviser that the Commission deems appropriate in the public interest and for the protection of investors or for the assessment of systemic risk, which may include the establishment of different reporting requirements for different classes of fund advisers, based on the type or size of private fund being advised.</p>
<p>Potential Changes to the Definition of "Client:"</p>	<p>Under the current interpretation of the Advisers Act, the term "client" includes only persons or entities that have a direct advisory relationship with the adviser. In the case of a private investment fund, the fund itself would be considered to be the client of the adviser, but the underlying investors in the fund would not be clients. The House Bill formally adopts this interpretation and prohibits the SEC from including the underlying investors of a private investment fund in the definition of "client" so long as such fund has entered into an advisory agreement with the adviser.</p>	<p>The Senate Bill provides the SEC with statutory authority to define the term client. If the PFIARA is adopted in its current form, the SEC could potentially define "client" to include the underlying investors in a private investment fund, which would have a significant impact on a registered adviser with respect to, among other things, its fiduciary duties to clients, the cash solicitation rule (Rule 206(4)-3), and the custody rule (Rule 206(4)-2). Note, however, that the SEC is not permitted to define the term "client" for the purpose of Section 206(1) and 206(2) to include an investor in a private fund managed by an investment advisor, if such private fund has entered into an advisory contract with such adviser.</p>
<p>Transition Period</p>	<p>The House Bill provides for a one year transition period from the date of enactment of the bill before the amendments to the Advisers Act become effective. As a result, unregistered advisers to private funds would not have to register with the SEC until 1 year after the House Bill's enactment.</p>	<p>The Senate Bill provides for a one year transition period from the date of enactment of the bill before the amendments to the Advisers Act become effective. As a result, unregistered advisers to private funds would not have to register with the SEC until 1 year after the Senate Bill's enactment.</p>

[1] See "Private Fund Investment Adviser Registration Act of 2009," a November 2009 O'Melveny Client Alert, available at <http://www.omm.com/private-fund-investment-advisers-registration-act-of-2009-11-12-2009/>.

[2] See "Private Fund Investment Adviser Registration Act of 2009," a December 2009 O'Melveny Client Alert, available at <http://www.omm.com/private-fund-investment-advisers-registration-act-of-2009-12-14-2009/>

[3] Under the current interpretation of the Advisers Act, the term "client" includes only persons or entities that have a direct advisory relationship with the adviser. In the case of a private investment fund, the fund itself would be considered to be the client of the adviser, but the underlying investors in the fund would not be clients.

[4] The House Bill and the Senate Bill each define a "private fund" as a fund that would be an investment company under Section 3 of the Investment Company Act of 1940, as amended (the "**1940 Act**"), but for the exceptions in Section 3(c)(1) or Section 3(c)(7) of the 1940 Act..



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