The Private Fund Investment Advisers Registration Act of 2009
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Introduction

On July 15, 2009, the Department of the Treasury published the *Private Fund Investment Advisers Registration Act of 2009*[i] ("the Registration Act"). If the Registration Act becomes law, it will require certain investment advisers to private funds ("Private Fund Advisers") to register with the Securities and Exchange Commission ("SEC").

Although there is no guarantee that the Registration Act will pass, President Obama will be meeting with Congress and Members to help persuade the enactment of its provisions. The Department of the Treasury's recent proposals for regulatory reform outlined that:

> "All advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold should be required to register with the SEC under the Investment Advisers Act."[ii]

In addition to this Act, Congress already is considering three other bills which could also require Private Fund Advisers to register with the SEC. These are the *Hedge Fund Adviser Registration Act of 2009*[iii], *the Hedge Fund Transparency Act*[iv] and *the Private Fund Transparency Act of 2009*[v].

In this article we consider two things: how the Registration Act will require Private Fund Advisers to register with the SEC and the practical consequences SEC registration will have for such firms.

Analysis of the Proposed Legislation

Private Fund Investment Advisers Registration Act of 2009

Advisers to Private Funds currently rely on a number of exemptions from registering with the SEC. These exemptions are contained in the Investment Advisers Act of 1940 ("Advisers Act") and certain SEC Rules.[vi] The Registration Act will amend the Advisers Act to prevent Private Fund Advisers from relying on the following three exemptions:

1. Advising less than fifteen clients in the preceding twelve months;[vii]
2. Providing intrastate advice in relation to non-listed securities;[viii] or
3. Registering with the Commodity Futures Trading Commission as a commodity trading adviser.[ix]

Most Private Fund Advisers rely on the first exemption on the basis that each Private Fund they advise only counts as one client.[x] This exemption will be removed from the Advisers Act entirely.[xi] The remaining exemptions will not be removed from the Advisers Act but Private Fund Advisers will be expressly excluded from relying upon them.[xii] For this purpose, a Private

Fund is essentially one that is exempt from registering as an investment company under sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 ("the Company Act"), although as discussed below, certain non-U.S. Funds are included in this definition.

Importantly, this does not mean that all Private Fund Advisers will have to register with the SEC. As long as the Adviser can rely on another exemption, it may still be able to avoid registration. For example, the Registration Act will not affect the exclusion that applies to investment advisers who have assets under management of less than $30,000,000. [xiii]

Who will be affected?

It is important to stress that the Registration Act will apply to most types of Private Fund Advisers.

Financial requirements aside, the key test for determining whether a firm or individual needs to register with the SEC is whether they "advise as to the value of securities or as to the advisability of investing in, purchasing, or selling securities" in exchange "for compensation."[xiv]

Private equity, venture capital, leveraged buy-out, mezzanine and distressed funds all invest in securities. Advisers to these funds therefore may need to register as investment advisers with the SEC.

In addition, the Registration Act also may affect certain offshore Fund Advisers and non-U.S. Advisers who use interstate commerce in the United States in connection with their business.[xv] For example, if an Adviser to an offshore Fund is based in the U.S. that Fund Adviser would need to register with the SEC since the Adviser is using interstate commerce to transact business on behalf of the offshore fund. However, the Registration Act also contains two exemptions which might apply.

First, although Advisers to non-U.S. Funds will no longer be able to rely on the "less than 15 clients" exemption, they will still be able to rely on the CTFC's exemption, provided that less than 10% of each Fund they advise is owned by U.S. persons.[xvi] Once this threshold is crossed, a Fund falls within the Registration Act's definition of a Private Fund.

Second, non-US Private Fund Advisers will not need to register with the SEC if they meet the Registration Act's definition of "Foreign Private Advisers." To meet this requirement, the Fund Adviser must advise less than fifteen U.S. clients in the preceding twelve months and manage less than $25,000,000 in assets attributable to U.S. clients.[xvii] For this purpose, it is possible that the SEC will treat each individual investor and not the Fund as the client. Although the SEC currently is prohibited from doing this,[xviii] Section 406 of the Registration Act repeals this prohibition by specifically authorizing the SEC to attribute different meanings to current definitions used in the Advisers Act, including the term "client". Nevertheless, those non-US Private Fund Advisers who manage only a small amount of assets for a small number of U.S. investors should still be able to take advantage of this exemption.

Consequences of Proposed Registration with SEC

Most of the provisions of the Advisers Act and the rules promulgated pursuant to it only apply to registered investment advisers. As such, Private Fund Advisers currently do not need to comply with these provisions. Should such advisers be required to register with the SEC, there are a number of fundamental and operational considerations the Private Fund will be subjected to, several of which are outlined below.

Compliance Procedures and Practices

Pursuant to Rule 206(4)-7 of the Advisers Act, all Private Fund Advisers would need to appoint a chief compliance officer and adopt and implement certain written policies and procedures designed to prevent violation of federal securities laws and test the effectiveness of these policies and procedures no less than annually. Advisers Act Release No. 2204 sets forth ten mandatory written policies and procedures. These relate to:

1. Portfolio management processes;
2. Trading practices;
3. Proprietary trading of the adviser and personal trading activities of supervised persons;
4. The accuracy of disclosures made to investors, clients, and regulators;
5. Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
6. The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
7. Marketing advisory services;
8. Processes to value client holdings and assess fees based on those valuations;
9. Safeguards for the privacy protection of client records and information; and
10. Business continuity plans.

Many Private Fund Advisers do not have written policies and procedures in place, even though in practice they may execute many of the above items required by the Advisers Act. Therefore, each Adviser should take inventory and consider what policies and procedures need to be developed based on existing internal controls.

It is important to note that this list is not comprehensive. Private Fund Advisers also will need to consider all conflicts of interest inherent to their business model and devise policies and procedures accordingly. For example, most private fund PPMs disclose that charging a performance fee creates a conflict of interest because it incentivizes the Private Fund Adviser to make potentially risky investment decisions in order to increase the size of the performance fee. With this in mind, SEC Rule 206(4)-7 would require Private Fund Managers to develop policies and procedures designed to prevent the firm from making investment decisions outside of its investment guidelines.

Performance Fees

SEC registered investment advisers are prohibited from charging performance fees to anybody but "qualified clients."[xix] The criteria for being a "qualified client" are extensive and vary

depending on the circumstances applicable to the client in question. As most Private Funds are organized as limited partnerships or limited liability companies, each Private Fund essentially need to have $750,000 under management to meet the definition of "qualified client."[xx] Further, each Private Fund investor must individually "qualify" before they can be charged a performance fee.[xxi] In the case of natural person investors, this means they either must have a net worth of more than $1,500,000 (which can be held individually or jointly with a spouse), invest at least $750,000 in private funds managed by the investment adviser or be associated with the investment adviser as an executive officer or investment advisory employee.[xxii]

Private Fund Advisers are not subject to these rules and consequently may charge performance fees to Private Funds that do not meet the definition of "qualified client." Many of these Funds may (at least temporarily) have less than $750,000 in assets. This most commonly occurs with incubator funds or newly formed Funds that are in the process of raising capital.

Alternatively, many private funds allow in investors who do not meet the definition of "qualified client." In order to avoid registering as investment companies and registering the sale of fund interests as securities, many funds limit investments to no more than 100[xxiii] "accredited investors," although up to 35 can be unaccredited."[xxiv] The requirements to qualify as an "accredited investor" generally are less stringent than the requirements pertaining to being a "qualified purchaser." For example, a natural person or a married couple only have to have a net worth of over $1,000,000 as opposed to $1,500,000 and this does not need to be complied with if the investor has an annual income of over $200,000 in the case of a single person or over $300,000 in the case of a married couple.[xxv] Consequently, many private funds have investors who meet the definition of "accredited investor" but not "qualified client," whereas others have investors who are not even "accredited investors."

If the Advisers Act is not amended, those Advisers to Private Funds which admit investors who are not "qualified clients" may need to register as an investment adviser with the SEC and cease charging performance fees in respect of such Funds or investors pursuant to Rule 205-3 of the Advisers Act.

Proxy Voting

SEC Rule 206(4)-6 provides that an investment adviser cannot vote proxies on behalf of a client without first having written policies and procedures in place to ensure that the proxies are voted in the best interests of that client. Although many hedge fund Advisers choose not to vote proxies, the position is different with venture capital and private equity funds. As these funds hold big position in smaller companies, part of the investment strategies adopted by these funds is contingent upon playing an active role in the management of these companies. Should the venture capital and private equity Private Fund Advisers vote proxies on a regular basis, this would require written policies and procedures under Rule 204(4)-(6).

Code of Ethics

Rule 204A-1 requires all investment advisers to establish, maintain and enforce a Code of Ethics ("Code"). At a minimum, this document must require certain personnel of the investment adviser

to report personal securities transactions and holdings and for the firm to periodically review those holdings and transactions. The purpose behind this is to prevent and detect any personal transaction which would be in contravention to the firm's fiduciary duty to a client. The rule also provides that the Code must prohibit acquiring securities in limited offerings or IPOs without first obtaining pre-clearance from the firm. Most firms go further than this and prohibit or require pre-clearance for transactions in specific or certain classes of securities. This may prove to be a dramatic procedural change for Private Fund Adviser personnel should the Adviser register with the SEC.

Books and Records

Rule 204-2a of the Advisers Act contains a detailed list of various books and records that all investment advisers must maintain. Private Fund Advisers will need to maintain and be able to readily access these books and records if they are required to register with the SEC.

Other Considerations

Currently, the Advisers Act provides guidance on various requirements pertaining to advertising, client disclosures and custody, which may or may not impact Private Fund Advisers who register with the SEC. For example, Rule 206(4)-1 contains detailed restrictions on investment adviser advertising. While unregistered Private Fund Advisers are prohibited from advertising, a registered Private Fund Adviser may advertise their services and hold themselves out to the public as investment advisers.[xxvi] However, in order to rely on any Regulation D exemption to registering fund interests as securities, the Adviser will still need to refrain from advertising about any of its specific Private Funds.[xxvii]

Rule 204-3 requires Advisers to develop and deliver a client brochure to existing and prospective clients. Most Advisers opt to use the Form ADV Part II for this purpose. This disclosure document contains important information about an Adviser's business model, investment strategies, investment risks and conflicts of interest. These subjects are often discussed in detail in a Private Fund's offering memorandum. In its current form, should Private Fund Advisers opt to use Form ADV Part II, they will need to ensure that information about its funds is generic enough as to not be deemed an advertisement in violation of Regulation D's exemptions.

Finally, some of the SEC's rules such as Rule 206(4)-2 (which concerns custody) and Rule 206(4)-8 (which concerns misleading statements in relation to pooled investment vehicles) already apply to Private Fund Advisers.

Additional Regulation Contained Within the Private Fund Investment Advisers Registration Act of 2009

In addition to the regulations described above, the Registration Act also contains a number of additional requirements that are not provided for within the current SEC regime. Importantly, Section 404 of the Registration Act will give the SEC powers to require Private Fund Advisers to maintain records and submit reports to the SEC concerning such matters "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."[xxviii] The Registration Act specifies that at a minimum, these reports and records would need to relate to the amount of assets under management, the use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading, investment positions, and trading practices.

Section 404 of the Registration Act also grants the SEC powers to require Private Fund Advisers to make certain mandatory disclosures to Fund investors, prospective investors, counterparties, and creditors. No specific examples are provided but such disclosures would need to be necessary or appropriate for "the protection of investors or for the assessment of systemic risk."[xxix]

Unless and until the Registration Act becomes law and the SEC starts using this rule making-authority, it is hard to predict how extensively and specifically these provisions of the Registration Act will affect Private Fund Advisers.

Conclusion

It remains to be seen whether either of the proposals that would require Private Fund Advisers to register as investment advisers will become law. Even if this does not transpire, it is important to note that all Private Fund Advisers have always been subject to the anti-fraud provisions of section 206 of the Advisers Act. In order to avoid infringing those provisions, Private Fund Advisers should consider adopting many of the policies and procedures required of currently registered investment advisers as a matter of best practice. Should any of the proposals become law, establishing requisite procedures now should make the transition to SEC registration, a less daunting process.

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[i] www.ustreas.gov, July 15, 2009, Private Fund Investment Advisers Registration Act of 2009, July 24, 2009 (http://www.treas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf).

[ii] www.wsj.com, June 17, 2009, Financial Regulatory Reform: A New Foundation, June 17, 2009 (http://online.wsj.com/public/resources/documents/finregfinal06172009.pdf).

[iii] H.R. 711, 111th Cong, 1st Sess.

[iv] S. 344, 111th Cong., 1st Sess. This would require certain Private Funds to register as investment companies. §203(b)(3) of the Investment Advisers Act of 1940 requires investment advisers to investment companies to register with the SEC.

[v] S. 1276, 111th Cong., 1st Sess.

[vi] Private Funds rely on separate exemptions contained within the Investment Company Act of 1940 to avoid registering as investment companies and the Securities Act of 1933 to avoid registering their interests as securities.

[vii] 15 U.S.C. §80b-3(b)(3).

[viii] Id at §80b-3(b)(1).

[ix] Id at §80b-3(b)(6).

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

[xi] Registration Act at §403.

[xii] Id at §403(a) and (c).

[xiii] C.F.R. §275.203A-1(a)(i).

[xiv] 15 U.S.C. §80b-2(a)(11).

[xv] Id at §80b-3(a).

[xvi] Registration Act at §402.

[xvii] Id.

[xviii]

[xix] Id. at §80b-5(a)(1) and C.F.R. §275.205-3(a).

[xx] C.F.R. §275.205-3(d)(1)(i).

[xxi] Id. at §275.205-3(c)(3).

[xxii] Id. at §275.205-3(d)(1).

[xxiii] 15 U.S.C. §80a-3(c)(1).

[xxiv] C.F.R. §275.506 (a)(2).

[xxv] Id. at §275.501(a).

[xxvi] 15 U.S.C. §80b-3(b)(3).

[xxvii] C.F.R. §275.502 (c).

[xxviii] Private Fund Investment Advisers Registration Act of 2009 at §404.

[xxix] Id.