



Senate Committee Takes up Investment Advisers Act Reforms

November 25, 2009 - Last week the Senate Committee on Banking, Housing and Urban Affairs began consideration of draft legislation that would, among other things, require many advisers to hedge funds or other private investment companies to register under the Investment Advisers Act of 1940 (the "Advisers Act"), to the extent they are not already so registered. These and other proposed revisions to the Advisers Act that are under consideration by the Committee are contained in Title IV of the Restoring American Financial Stability Act of 2009 ("RAFSA"), the sweeping proposed reform of financial regulation recently unveiled by Committee Chairman Chris Dodd. The most recent available draft of RAFSA (including Title IV) is the "Chairman's Mark Text" (available [here](#)).

The portion of RAFSA relating to Advisers Act reforms (*i.e.*, Title IV of RAFSA), is similar to several other proposals that have been made, including H.R. 3818, which is currently pending in the House of Representatives. (Although there have been multiple versions of H.R. 3818, all references in this Alert are to the version of H.R. 3818 that was approved on October 27, 2009 by the House Financial Services Committee.)

H.R. 3818 was discussed extensively in an October 30, 2009 Alert (available [here](#)) published by our Task Force on Modernizing Financial Services Regulation. The below discussion focuses particularly on how Title IV of RAFSA compares to H.R. 3818.

Exemptions for Certain Advisers to Private Equity Funds

Title IV of RAFSA and H.R. 3818 both would generally repeal the Advisers Act exemption that currently enables advisers with fewer than 15 clients to avoid registering under the Act (the "15 Client Exemption"). This would require many advisers to hedge funds and other private investment funds to register under the Advisers Act, to the extent they are not already so registered. To cushion any adverse effects from this, Title IV of RAFSA and H.R. 3818 both would provide certain additional exemptions from Advisers Act registration, including for advisers to (i) venture capital funds or (ii) small business investment companies.

Title IV of RAFSA (but not H.R. 3818) would go further and also provide an exemption from Advisers Act registration for advisers to "private equity" funds. This is widely regarded as reasonable, insofar as private equity funds have not

to date been identified as having contributed to the problems in the financial markets. On the other hand, the SEC and others have pointed out the difficulty of precisely defining the concept of a private equity fund in order to treat such funds differently than, for example, hedge funds. At the edges, the definitional lines around such entities may be blurred. Title IV does not attempt any substantive resolution of the definitional problem, but merely mandates that the SEC develop an appropriate definition of a private equity fund.

Although Title IV of RAFSA would exempt private equity fund advisers from registration under the Advisers Act, it would nevertheless require that such advisers maintain such records and file such reports with the SEC as the SEC shall prescribe as necessary or appropriate in the public interest and for the protection of investors.

Advisers to Certain Small Private Investment Funds

H.R. 3818 would generally exempt from Advisers Act registration any private fund adviser, if each advised private fund has assets under management in the United States of less than \$150 million (the "\$150 Million Exemption"). Such exempt advisers would still be required by the SEC to maintain certain records and file certain reports with the SEC, however.

Title IV of RAFSA does not contain any provision comparable to the \$150 Million Exemption. Some private fund advisers with relatively small amounts of assets under management may nevertheless be able to rely on Section 203A(1)(a)(A) of the Advisers Act, which is discussed further below, in order to avoid registration under that Act. However, the threshold for assets under management would in any case be less under Section 203A(1)(a)(A) than under the \$150 Million Exemption, and Section 203A(1)(a)(A) (unlike the \$150 Million Exemption or the 15 Client Exemption) also is conditioned on the adviser being registered as an investment adviser in the state where it maintains its principal office and place of business.

Exclusion for "Family Offices"

One consequence of repealing the 15 Client Exemption, of course, is that an office that manages the financial affairs of a single wealthy family (a "Family Office") could be subject to the Advisers Act's registration requirement. Thus, Title IV of RAFSA would exclude from the Advisers Act any Family Office, as defined by the SEC. H.R. 3818 contains no comparable provision.

Registered Adviser Records for Private Funds

Title IV of RAFSA and H.R. 3818 both would require that advisers who are registered under the Advisers Act maintain such records and file such reports regarding private funds they advise as the SEC may deem necessary or appropriate for the protection of investors or for the assessment of systemic risks. Although the SEC would therefore have broad authority to require records and reports, both Title IV of RAFSA and H.R. 3818 would require that such advisers at least maintain the following information about each private fund:

- the amount of its assets;
- its use of leverage;

- counterparty risk exposure;
- trading and investment positions; and
- trading practices.

Title IV of RAFSA, moreover, also would require registered advisers to maintain additional information (beyond what would be required by H.R. 3818) about private funds, including;

- valuation methodologies;
- types of assets held; and
- any side arrangements or letters whereby certain investors in a fund obtain more favorable rights or entitlements than other investors.

Additional Regulation of Private Funds

The last item listed above (*i.e.*, information about arrangements that treat some investors more favorably than others) is of particular interest, because it reflects a regulatory concern that seems to bear little relationship to the types of systemic risk that have been the primary motivation of RAFSA and its enhanced regulation of private fund advisers. This implies the possibility of future regulatory or disclosure initiatives in this area.

Also, Title IV of RAFSA would require the Comptroller General of the United States to conduct a study on:

- the appropriate criteria for determining accredited investor status for purpose of eligibility to invest in hedge funds;
- the feasibility of forming a self-regulatory organization to oversee hedge funds, private equity funds, and venture capital funds; and
- the "state of short selling in the stock market."

These study items, which have no counterpart in H.R. 3818, could, of course, result in new regulatory or disclosure initiatives that could affect certain private funds, as well as other types of advisory accounts.

On the other hand, Title IV of RAFSA omits a new disclosure requirement that would be provided under H.R. 3818. Specifically, H.R. 3818 (but not Title IV) would empower the SEC to require that SEC-registered advisers to private funds provide investors, prospective investors, counterparties, and creditors with such reports, records and other documents concerning such private funds as the SEC may prescribe as necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risks. This is a remarkably broad provision, in that it would authorize the SEC to impose disclosure obligations with respect to private funds that might even exceed the disclosure obligations of fully-registered mutual funds.

Independent Custody of Client Assets

Title IV of RAFSA (but not H.R. 3818) would direct the SEC to prescribe rules requiring SEC-registered advisers to use an independent custodian to hold client assets, where necessary and appropriate in the public interest and for the protection of investors.

Amendment to Advisers Act Section 203A(a)(1)(A)

Currently, Section 203A(a)(1)(A) of the Advisers Act provides that an investment adviser that has assets under management of less than \$25 million, or such higher amount as the SEC may specify, cannot register under the Advisers Act if such adviser is regulated as an investment adviser in the state in which it maintains its principal office and place of business. Title IV of RAFSA, but not H.R. 3818, would raise this amount to \$100 million. This would substantially reduce the number of investment advisers that are subject to SEC registration. Investment advisers that are no longer subject Advisers Act registration, however, would no longer be entitled to rely on certain provisions that partially preempt state regulation of investment advisers. Accordingly, the proposed change in Section 203A(a)(1)(A) would increase the reach of such state regulation.

For additional information:

Jorden Burt has formed a special Task Force to monitor this legislation and other proposals relating to reform of financial services regulation. To obtain additional information about particular proposals that might have an impact on the insurance or reinsurance industries, you may contact Roland Goss (rcg@jordenusa.com or (202) 965-8148). To obtain additional information about particular proposals that might have an impact on the investment adviser and fund industries, you may contact Tom Lauerman (tcl@jordenusa.com or (202) 965-8156). Or you may contact any of Jorden Burt's other regulatory attorneys.

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