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Treasury Proposes Registration of Fund Advisers; SEC Testifies in Support

2009-07-16

On July 15, the Department of the Treasury delivered to Congress draft legislation that would amend the federal securities laws to require the registration of investment advisers to hedge funds and other private investment pools. Treasury's June 17, 2009 white paper on financial regulatory reform ("White Paper") recommended these changes.[1] The "Private Fund Investment Advisers Registration Act of 2009" effectively would remove the private adviser exemption from registration for investment advisers with a place of business in the United States. The legislation thus would require registration under the Investment Advisers Act of 1940 of all managers of hedge funds, private equity funds, venture capital funds and family offices, other than those with less than $30 million of assets under management.[2]

The main goal of the legislation would be to require the registration of advisers to any "private fund." The legislation defines a "private fund" to mean any investment company that is defined in section 3 of the Investment Company Act of 1940 "but for section 3(c)(1) or 3(c)(7)" and that is either organized in or created under the laws of the U.S. or that has 10 percent or more of its outstanding securities owned by U.S. persons. Registration would be required even if all the funds advised by an adviser are in one state, although the draft retains the exemption from registration for intrastate advisers, all of whose clients reside in the state within which the adviser maintains its principal office. The legislation would retain a limited private adviser exemption for foreign investment advisers (those with no place of business in the U.S.), but only if they have fewer than 15 U.S. clients and assets under management attributable to U.S. clients of less than $25 million.

The legislation would authorize the Securities and Exchange Commission to require investment advisers to maintain and submit to the SEC and the Board of Governors of the Federal Reserve System any records regarding private funds they advise that are "necessary or appropriate" for the assessment of systemic risk. It does not define systemic risk but provides that required records and reports would include "assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposure, trading and investment positions, and trading practices," as well as any other information that the SEC, in consultation with the Federal Reserve, determines is necessary or appropriate.

The Treasury's fact sheet accompanying the legislation states that adviser reporting would be "confidential," but the proposed statutory language does not fulfill that promise. First, the provision purporting to keep confidential the information reported to the SEC and other federal agencies is too narrowly drafted to accomplish the stated goal, potentially exposing a variety of private information that advisers have about individual investors to possible public disclosure. Second, the SEC would be authorized to make rules requiring advisers registered pursuant to the legislation to provide such information to investors, potential investors, counterparties, and creditors as may be necessary or appropriate in the public interest and for the protection of investors or the assessment of systemic risk. This would seem to give the SEC broad authority to order public disclosure of a wide range of information, including personal and private investor information. Some restriction and refinement of that draft provision would be worth considering. Finally, the legislation would remove the provision in Section 210 of the Advisers Act that prohibits any requirement to disclose the identity of or information about an adviser's clients. This was a fundamental protection Congress thought essential when it created an adviser examination requirement.

The SEC would be authorized to prescribe examination procedures for any records of a private fund maintained by a registered investment adviser. Notably, this draft provision does not require that examinations be reasonable, a protection that exists in the current law permitting examinations of investment advisers, registered investment companies, broker-dealers, and others. The SEC would be required to provide to the Federal Reserve and the new Financial Services Oversight Council proposed in the White Paper those records that may be necessary to assess systemic risk.

The legislation also would clarify the SEC's rulemaking authority under the Advisers Act regarding, among other things, the form and content of the reports required to be filed by advisers dually registered with the SEC and the Commodity Futures Trading Commission.

Finally, the legislation would give the SEC extremely broad rulemaking authority to define terms used in the Advisers Act, including the ability to "ascribe different meanings to terms (including the term 'client') used in different sections of [the Advisers Act] as the Commission determines necessary to effect the purposes of [the Advisers Act]." This appears to be an attempt to reverse the 2006 *Goldstein* ruling by the U.S. Court of Appeals for the District of Columbia Circuit, which struck down a rule that would have required registration of most hedge fund advisers.[3] This proposed authority could vest the SEC with a great deal of discretionary authority to redefine terms used in the statute. Like the confidentiality provision, some restriction and refinement of this authority would be worth considering.

Also on July 15, the SEC testified before the Securities, Insurance, and Investment Subcommittee of the Senate Banking Committee in support of the "Private Fund Transparency Act of 2009" ("S. 1276"), introduced in June by Senator Jack Reed. S. 1276 is substantially similar to Treasury's draft legislation, although Treasury's legislation is more detailed. The SEC was represented by its Director of Investment Management, Andrew Donohue.

Mr. Donohue testified that the SEC generally supports S. 1276, stating that: "[i]nvestment adviser registration in our view is appropriate for any investment adviser managing $30 million regardless of the form of its clients or the types of securities in which they invest."

Mr. Donohue also suggested two alternative approaches, including the registration of private funds under the Investment Company Act, or "to provide the Commission with the authority that allows for additional regulatory flexibility to act in this area. This could be done by providing rule-making authority to condition the use by a private fund of the exceptions provided by sections 3(c)(1) and 3(c)(7) of the Investment Company Act. These conditions could impose those requirements that the Commission believes are necessary or appropriate to protect investors and enhance transparency." Neither S. 1276 nor the Treasury's draft legislation adopt these alternative approaches.

The SEC's testimony was not unanimously supported by the Commissioners. Commissioner Paredes did not endorse the testimony; Commissioner Casey supported registration of investment advisers, but did not endorse the other approaches.

The SEC's testimony is significant, because it is the first time the agency has taken a definite position on registration of hedge fund advisers since the *Goldstein* decision. It is also significant because the SEC, consistent with Treasury's proposed legislation, is now supporting registration of other investment advisers as well, including those that advise venture capital funds, private equity funds, and family offices.

[1] The draft legislation is available here.

[2] Under Section 203A of the Advisers Act, which would not be affected by the legislation, with very limited exceptions, investment advisers with less than $25 million in assets under management are prohibited from registering with the SEC. Rule 203A-1 essentially makes SEC registration optional for advisers with assets under management between $25 million and $30 million. Advisers that are not registered with the SEC must evaluate whether they are required to register under any state laws.

[3] *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

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