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A legal update from Dechert's Financial Services Group

The Impact of the Restoring American Financial Stability Act of 2010 on Private Fund Advisers

The U.S. Senate approved on May 20, 2010 the Restoring American Financial Stability Act of 2010 (S. 3217) (the "Bill"), a comprehensive regulatory reform bill that would make significant changes to the regulatory framework and level of supervision of the financial services industry. "Title IV – Regulation of Advisers to Hedge Funds and Others" of the Bill, cited therein as the "Private Fund Investment Advisers Registration Act of 2010" (the "Advisers Registration Act") sets forth parameters for federal and state registration of investment advisers and introduces additional provisions relating to advisers to venture capital and private equity funds, investor accreditation, and requirements for further studies and reports relating to the private fund industry.

The Advisers Registration Act would become effective one year after the date of enactment of the Bill, with the expectation that investment advisers will comply with the provisions of the Bill prior to the expiration of the one-year transition period. For investment advisers to most private funds, this entails registering with the Securities and Exchange Commission (the "Commission") within such time, if not already registered, and conducting a comprehensive review of the adviser's policies and procedures to ensure compliance with best practice standards and the provisions of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), as modified by the Bill, prior to registration.

Modification to Registration Provisions

The Advisers Registration Act would raise the threshold for permitted federal registration of a private fund[1] adviser under Section 203A of the Advisers Act, from $25 million to $100 million in assets under management, and thus leave to the states the exclusive responsibility for supervising private fund advisers with less than $100 million in assets under management.

The Advisers Registration Act also would make private fund advisers ineligible to rely on the current exemption from registration for intra-state investment advisers set forth in Section 203(b)(1) of the Advisers Act, by requiring intra-state investment advisers to private funds to register with the Commission.

[1] A "private fund" is defined broadly under the Advisers Registration Act as any issuer that would be an "investment company" under the Investment Company Act of 1940, as amended (the "Investment Company Act"), but for the exceptions set forth in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.

Filing Obligations

Under the Advisers Registration Act, the Commission would be able to require a registered adviser to a private fund to maintain and file with the Commission certain information relating to each private fund it advises that is relevant to the protection of investors and assessment of systemic risk. Such information would include:

- assets under management;
- information on the use of leverage;
- counterparty credit risk exposure;
- valuation policies and procedures;
- types of assets held;
- side letters;
- trading practices; and
- such other information as the Commission in consultation with Financial Stability Oversight Council (the "Council") may determine, which may vary based on the type or size of the private fund advised by the investment adviser.

The Commission would be required to periodically examine all records maintained by registered advisers to private funds and be able to examine records at such other times as it may determine. Information gathered and shared under Section 404 of the Advisers Registration Act with the Council or any department, agency, or self-regulatory organization that receives such reports or information from the Commission, would be handled in a manner consistent with provisions for confidential treatment of such records and reports that would be added under this Section. Private funds' "proprietary information," as defined under Section 404, would not be considered public information (i.e., not subject to FOIA requests), although the Commission would be required to report annually to Congress on how the Commission has used the data it has collected.

Exemptions for VC/PE Fund Advisers/Family Offices

The Advisers Registration Act would provide exemptions from the registration requirements of the Advisers Act for investment advisers to venture capital funds and private equity funds. Within six months of the date of enactment of the subsections pertaining to the respective exemptions, the Commission would be required to define the term "venture capital fund" and the term "private equity fund" and issue final rules regarding records and reports to be maintained by advisers to private equity funds, based on fund size, governance, investment strategy, risk and other factors as the Commission shall determine. The Commission would not be required under the Advisers Registration Act to impose recordkeeping and reporting obligations on venture capital funds. The Advisers Registration Act would add a "family office" exemption from the definition of "investment adviser" under the Advisers Act, and thus from the registration requirements thereunder, with the Commission to define the term "family office" in a manner consistent with regulatory relief granted in the past and that "recognizes the range of organizational, management and employment structures and arrangements employed by family offices."

Foreign Private Fund Adviser Exemption

Under the Advisers Registration Act, the Section 203(b)(3) exemption from registration based on the number of an adviser's clients would be replaced by an exemption from registration for any investment adviser that is a "foreign private fund adviser," which is defined as an investment adviser that: (i) has no place of business in the U.S.; (ii) has less than $25 million in aggregate 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; (iii) has, in total, fewer than 15 clients that are domiciled in, or residents of, the U.S.; and (iv) neither (a) holds itself out generally to the public in the U.S. as an investment adviser nor (b) advises registered investment companies. The Commission would be granted the authority to raise the $25 million dollar threshold.

Other Provisions

The Commission would be required to increase the net worth and income level required for natural persons to qualify as accredited investors not less than once every five years, to reflect the percentage increase in the cost of living.

Further, the General Accounting Office would be required to conduct a study on the feasibility of creating a self-regulatory organization governing private funds.

Finally, the Division of Risk, Strategy, and Financial Innovation of the Commission would be required to conduct a study on the impact of short selling on national securities exchanges and over-the-counter markets.

Conclusion

The Bill will now be reviewed in conference committee to reconcile the differences between the Bill and the financial reform bill passed by the House of Representatives late last year ("H.R. 4173"). In order for the Bill to be presented to the President, both the House and the Senate must agree on a compromise version and approve the conference committee's report. While there have been numerous proposals to reform legislation governing private funds and their advisers since 2008, the Advisers Registration Act appears to be widely endorsed across party lines and the majority of the provisions of the Bill that pertain to private fund adviser registration and regulation are substantially the same as those proposed in H.R. 4173.[2] Although the legislative process and executive review are not complete, based on the sentiment reported by legislators and the President, it appears likely that a new law following the general parameters described in this update will be adopted.

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[2] See the attached EXHIBIT for a summary of the differences between the Bill and H.R. 4173 to be reconciled.

EXHIBIT

Private Fund Investment Advisers Registration Act

Provisions[3]	Senate Bill (Advisers Registration Act)	House Bill (H.R. 4173)
Private Adviser Exemption	Would replace current 15 client exemption set forth in Section 203(b)(3) with the foreign private fund adviser exemption.	Same.
Private Fund Definition	An issuer that would be an investment company but for the exceptions set forth in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.	Same.
Threshold for Federal Registration	Would raise the threshold for permitted federal registration of an adviser from $25 million to $100 million in assets under management.	Would increase the threshold for permitted federal registration of an adviser that acts solely as an adviser to a private fund from $25 million to $150 million in assets under management (which assets under management must be in the United States).
Intrastate Exemption	Would exempt from registration advisers with all clients resident in the same state, unless such adviser advises a "private fund" as defined above.	Same.

3 This chart provides brief summary information only respect to certain terms of the Senate (Advisers Registration Act) and House (H.R. 4173) versions of the Private Fund Investment Advisers Registration Act. Below are links to drafts of the Advisers Registration Act and H.R. 4173, respectively:

http://banking.senate.gov/public/_files/HR_4173_Senate_passed_as_amended.pdf;

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173rfs.txt.pdf.

Provisions[3]	Senate Bill (Advisers Registration Act)	House Bill (H.R. 4173)
Foreign Adviser Exemption	Would exempt from registration a "foreign private fund adviser," which is defined as an investment adviser that: (i) has no place of business in the U.S.; (ii) has less than $25 million in aggregate 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; (iii) has, in total, fewer than 15 clients who are domiciled in, or residents of, the U.S.; and (iv) neither (a) holds itself out generally to the public in the U.S. as an investment adviser nor (b) advises registered investment companies. The Commission would be granted the authority to raise the $25 million dollar threshold.	Generally the same, except that (i) in calculating the 15 client limit and $25 million threshold, Bill refers to clients and investors in private funds advised by the investment adviser, thus creating the potential requirement to "look-through" a private fund to the underlying investors when determining these amounts, and (ii) a foreign private fund adviser would only need to count U.S. clients and investors it has had over the preceding 12 months.
Investor Accreditation	Would require the Commission to increase the net worth and income level required for natural persons to qualify as accredited investors not less than once every five years to reflect the percentage increase in the cost of living.	Would require the Commission to increase any dollar amount threshold associated with the determination of the qualified client standard under the Advisers Act to be adjusted within one year of the enactment of the Act and then every five years thereafter to reflect the effects of inflation on such standard.
Commodity Trading Advisor Exemption	Does not substantively alter the commodity trading advisor exemption set forth in Section 203(b)(6).	Would exempt from registration any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor whose business does not consist primarily of acting as an investment adviser so long as such investment adviser does not act as an investment adviser to a registered investment company or a private fund.

Provisions[3]	Senate Bill (Advisers Registration Act)	House Bill (H.R. 4173)
Recordkeeping and Reporting by Private Funds	Would authorize the Commission to require registered advisers to maintain records and file reports (which may be made available to systemic risk regulators), including information on assets under management, the use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies and practices, types of assets held, side letters, trading practices, and such other information as the Commission in consultation with the Financial Stability Oversight Council may determine, which may vary based on the type or size of the private fund advised by the investment adviser.	Generally the same, except H.R. 4173 also would have required registered advisers to provide "such reports, records and other documents to investors, prospective investors, counterparties and creditors" of any private fund advised by the investment adviser as the Commission prescribes by rule or regulation.
Venture Capital Fund Exemption	Would exempt from registration advisers to "venture capital funds" (as defined by the Commission).	Same, except H.R. 4173 would have authorized the Commission to impose recordkeeping and reporting obligations on advisers to venture capital funds.
Private Equity Fund Exemption	Would exempt from registration advisers to "private equity funds" (as defined by the Commission). Would require the Commission to issue final rules regarding records and reports to be maintained by advisers to private equity funds.	No separate exemption specifically for advisers to private equity funds.
Small Business Investment Companies	Would exempt from registration an investment adviser who solely advises small business investment companies.	Same.
Family Office Exemption	Would exclude from the definition of "investment adviser" any "family office" (as defined by the Commission).	No separate exclusion provided specifically for "family offices."

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

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