

From the Bar...

## **Spotlight on Investment Adviser Registration — Obama Administration and Congress Move Forward with Regulatory Reform Agenda**

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Since the financial market turmoil began in 2008, academics, legislators, and market participants have been clamoring for increased federal regulatory oversight and controls over the United States financial markets. In June 2009, President Obama officially announced his administration's proposals for reform of financial industry regulations (the "Proposals").<sup>1</sup> The Proposals were broad in scope and established an ambitious plan to achieve five key objectives. Among those objectives were promoting robust supervision and regulation of financial firms, establishing comprehensive supervision of financial markets, and protecting consumers and investors from financial abuse. To accomplish the Proposals' five key objectives, the Proposals recommended, among other things, mandatory registration with the Securities and Exchange Commission (the "SEC") of all investment advisers (including advisors to hedge funds, private equity funds and venture capital funds) whose assets under management exceeded some modest threshold. The Proposals also called for enhanced record-keeping, disclosure, regulatory reporting, and regulatory powers.

Both before and after the Proposals were released, the administration and Congress have been hard at work crafting specific federal investment adviser registration provisions. In response, many potentially affected investment advisers have joined industry groups in an effort to provide meaningful input to members of Congress, while closely examining their operations, personnel and resources to prepare for anticipated new regulations and increased regulatory scrutiny. The following article examines the federal investment adviser registration proposals to date and investment adviser responses thereto in more detail.

1. See, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*, available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf)

## Obama Administration Proposed Legislation

In July 2009, the Obama administration delivered proposed legislation to Congress that was designed to further its regulatory reform agenda. The administration's "Private Fund Investment Advisers Registration Act of 2009" would expand the pool of investment advisers required to register with the SEC by eliminating the portion of Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Act") that exempts from registration investment advisers with fewer than fifteen clients that do not hold themselves out to the public as investment advisers.<sup>2</sup> Because managers to private investment funds are currently able (generally) to count each "fund" as a single client, many managers rely on this exemption to avoid registration.

In cases where an investment adviser advises a "private fund" (e.g., hedge fund, private equity fund and venture capital fund), this proposed legislation also eliminates (i) the "intrastate exemption" from registration under the Act and (ii) the "CTA exemption" from registration under the Act. The intrastate exemption is available to advisers whose clients are residents of a single state where the adviser maintains its principal office and place of business. To rely upon this exemption, an investment adviser must not furnish advice or issue analyses or reports with respect to securities listed, or admitted to unlisted trading privileges, on a national securities exchange. The CTA exemption is available to advisers that are registered with the Commodity Futures Trading Commission as Commodity Trading Advisors. To rely on this exemption, the advisers' business must not consist primarily of acting as an investment adviser and the advisers must not act as investment advisers to any registered investment company.

The administration's proposed legislation would also subject registered investment advisers to the following: (i) enhanced record-keeping requirements; (ii) investor, creditor and counterparty disclosure requirements; and (iii) regulatory reporting requirements (including the reporting of assets under management, borrowings, investment positions and trading practices on a confidential basis). These record-keeping and reporting requirements would apply not only to a registered investment adviser, but also to each "private fund" advised by an investment adviser.

Finally, the Private Fund Investment Advisers Registration Act of 2009 clarifies the SEC's rulemaking authority, including the ability to ascribe different meanings to terms used in

the Act (e.g., the term "client") and removes the prohibition on the SEC from requiring an investment adviser to disclose the identity of its clients, under certain circumstances.<sup>3</sup>

## Proposed Legislation in Congress

With the exception of certain notable changes (e.g., the elimination of the intrastate and CTA exemptions for advisers that advise "private funds"<sup>4</sup>), the administration's proposed legislation is substantially similar to the "Private Fund Transparency Act of 2009," which was introduced in the U.S. Senate by Senator Jack Reed (D-Rhode Island) in June 2009 (approximately one month prior to the release of the administration's Private Fund Investment Advisers Registration Act of 2009).<sup>5</sup> After the release of the Private Fund Transparency Act of 2009 and the administration's Private Fund Investment Advisers Registration Act of 2009, Representative Paul Kanjorski (D-PA), Chair of the House Capital Markets Subcommittee, released draft legislation also entitled the "Private Fund Investment Advisers Registration Act of 2009".<sup>6</sup> Representative Kanjorski's draft legislation is substantially similar to the administration's and Senator Reed's proposed legislation described above, with the exception of the treatment of investment advisers to venture capital funds.

Representative Kanjorski's draft legislation exempts investment advisers who advise "venture capital funds" from registration. This draft legislation, however, avoids specific details on the qualifications necessary to meet this exemption, and provides the SEC with the authority to define the term "venture capital fund." Notwithstanding that such advisers would be exempt from registration, the draft legislation directs the SEC to mandate certain record-keeping and reporting requirements for advisers to venture capital funds.<sup>7</sup>

3. A "private fund" is any investment fund that would be an investment company but for the exemptions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended.

4. See Section 210(c) of the Act for a description of the prohibition on the SEC from requiring an investment adviser to disclose the identity of its clients under certain circumstances.

5. See, *Private Fund Transparency Act of 2009*, available at <http://thomas.loc.gov/cgi-bin/query/z?c111:S.1276>:

6. U.S. House of Representatives Bill 711, the "Hedge Fund Adviser Registration Act of 2009," introduced by Representative Michael Capuano (D-MA) prior to the Proposed Legislation, would also broaden the pool of investment advisers required to register with the SEC by eliminating Section 203(b)(3) of the Act.

7. On October 27, 2009, the House Financial Services Committee approved the Private Fund Investment Advisers Registration Act of 2009 with amendments. As amended by the House Financial Services Committee, the bill provides exemptions from registration for investment advisers who advise "venture capital funds" (as defined in future rulemaking by the SEC) and investment advisers who manage less than \$150 million in assets (although the SEC would have authority to regulate advisers managing less than \$150 million in assets if it determines that these advisers pose systemic risk to the financial system). If passed in its current form, there would be a one-year grace period (from the date of its passage) for investment adviser compliance.

2. The proposed legislation provides for the placement in Section 203(b)(3) of the Act of an exemption from registration for certain "foreign private advisers."

U.S. House of Representatives Bill 3817, the “Investor Protection Act of 2009,” would also require the registration with the SEC of investment advisers who manage more than \$100 million in assets.<sup>8</sup> Similarly, a discussion draft of Senate legislation proposed by Senator Chris Dodd (D-Connecticut) on November 10, 2009 (collectively with the administration’s proposal, Senator Reed’s proposal, the Private Fund Investment Advisers Registration Act of 2009 proposed in the House of Representatives, and the Investor Protection Act of 2009, the “Proposed Legislation”) would eliminate that portion of Section 203(b)(3) of the Act that currently exempts from registration investment advisers with fewer than fifteen clients that do not hold themselves out to the public as investment advisers. Senator Dodd’s proposed legislation, however, exempts certain “foreign private advisers”, advisers to “venture capital funds”, advisers to “private equity funds”, and advisers who manage less than \$100 million in assets from registration. Private equity fund advisers would still be subject to record-keeping and reporting under the proposed legislation.

The proposed legislation also removes “family offices” from the purview of the Act. The SEC would define “venture capital funds”, “private equity funds” and “family offices” in future rulemaking under the proposed legislation.

Viewed together, the Proposed Legislation reveals a focus on investment adviser registration as a favored method of regulating private investment funds in response to the recent market turmoil. However, current legislative actions, including the Proposed Legislation, also place regulatory focus on pooled investment vehicles<sup>9</sup> themselves, in addition to investment advisers that manage such vehicles. It also appears likely that federal legislation and rulemaking will pre-empt or deter certain state legislation and rulemaking in response to the recent (and possibly, current) financial crises, at least for relatively large financial institutions.

## Moving Forward in Light of Proposed Investment Adviser Legislation

Based on the Proposed Legislation and other legislative actions, increased regulation and monitoring of investment advisers to pooled investment vehicles appears probable. Many investment advisers have joined industry groups in an effort to educate lawmakers as to the potential costs and burdens of additional investment adviser registration, monitoring, reporting and disclosure versus its perceived benefits. In addition to these efforts, many investment advisers (particularly unregistered investment advisers to pooled investment vehicles) have begun thorough reviews of their operations, personnel and resources to ensure compliance with anticipated regulations enforced by more frequent regulatory examinations. These reviews focus on, among other things, the following areas: (i) safety of investor assets; (ii) valuation; (iii) institutional conflicts; (iv) personal conflicts; (v) procedures designed to prevent and detect market manipulation; (vi) marketing practices; (vii) regulatory reporting procedures; (viii) risk disclosures; (ix) procedures designed to prevent and detect the misuse of material non-public information and firm proprietary information; (x) investment guidelines and restrictions; and (xi) record retention and destruction. Investment advisers are well advised to seek the help of third party professionals, such as accountants and attorneys, when conducting these reviews and implementing new or improved policies and procedures designed to address existing or anticipated laws, rules and regulations.



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8. The Investor Protection Act of 2009 was introduced by Congressman Paul Kanjorski (D-Pennsylvania) on October 15, 2009. The bill was passed by the House Committee on Financial Services with amendments on November 4, 2009.

9. In addition to the Proposed Legislation, U.S. Senate Bill 344, the “Hedge Fund Transparency Act of 2009,” introduced by Senators Chuck Grassley (R-IA) and Carl Levin (D-MI) prior to the release of the Proposed Legislation, would require most hedge funds, private equity funds, venture funds and structured finance vehicles having \$50 million or more under management to register with the SEC and file a publicly-available annual information form, maintain books and records in a manner required by the SEC and generally cooperate with requests for information and examinations by the SEC. This bill also would require funds to establish anti-money laundering compliance programs and report suspicious transactions.