

# FS Regulatory Brief\*

## Private Fund Investment Advisers Registration Act of 2009

On July 15th the Obama Administration delivered proposed legislation to Capitol Hill requiring nearly all investment advisers to private investment pools (hedge funds, private equity funds, venture capital funds) to register with the SEC and subjecting them to new reporting and recordkeeping requirements. The proposed legislation is known as the Private Fund Investment Advisers Registration Act of 2009 and its stated objectives include:

- assisting the SEC in protecting investors from fraud and abuse;
- increasing transparency; and
- providing regulators with sufficient information to monitor and manage potential systemic risk.

This Brief provides an overview of the proposed Act's requirements and highlights potential areas of consideration as the legislation is debated. We will issue a more thorough analysis of the legislation as it works its way through Congress. We have also provided a brief summary of the requirements that will be imposed on newly registered advisers.

### Registration

By amending Section 203(b) of the Investment Advisers Act, the proposal eliminates the private adviser exemption for U.S. advisers. It requires all U.S. investment advisers to private investment funds and with more than \$30 million under management to register with the SEC.

A private-adviser exemption would still be available to any foreign adviser that had less than 15 clients in the United States, less than \$25 million attributable to U.S. clients, and did not hold itself out generally as an adviser in the U.S.

The proposed legislation also requires a foreign investment adviser who advises an offshore fund with 10 percent or more of its outstanding securities owned by U.S. persons to register with the SEC. Although it is not clear, it appears that this requirement is intended to apply regardless of the size of the offshore fund or the number of US investors.

The draft Act does not give any indication about transition periods between final passage and required registration, and this important point will have to be clarified in the legislative process or by SEC rulemaking.

This latest attempt to require registration of hedge fund managers is clearly distinct from prior attempts. The last attempt by the SEC in 2004 required fund managers to count all of the investors in the fund as clients of the adviser. This resulted in fund managers not being able to rely on the private adviser exemption (fewer than 15 clients) of Section 203(b)(3) of the Investment Advisers Act. This time, by completely eliminating the private adviser exemption for U.S. advisers, the draft Act would capture all advisers to private pools of capital. It may, however, also have unintended consequences for other non-registered U.S. separate -account advisers with small client bases.

Prior attempts to register hedge fund advisers also attempted to exclude private equity and venture capital fund managers by providing exemptions for funds with long lock-up periods. With the broad language noted in the proposed Act, the scope of firms to be affected will range across all private investment pools including hedge funds, private equity funds and venture capital funds.

### Regulatory Reporting

As part of the proposed legislation, any registered investment adviser to a private fund is required to maintain records and to submit reports to the SEC regarding its private funds. The proposed legislation provides a list of records and reports which includes,

but is not limited to the following, for each private fund:

- Amount of assets under management,
- Use of leverage (including off-balance sheet leverage),
- Counterparty credit risk exposures,
- Trading and investment positions, and
- Trading practices

The SEC will make information relating to the private funds available to the Board of Governors of the Federal Reserve System and the Financial Services Oversight Council that is considered necessary to determine and assess the systemic risk of a private fund or assessing whether a private fund should be designated a Tier 1 financial holding company.

The proposed legislation requires the confidentiality of the information contained in the reports and records required to be filed with the SEC, something for which the industry has lobbied hard. While the proposed Act does require the confidentiality of information provided to the SEC, it does permit that information to be shared with Congress. Some in the industry are concerned about whether information provided to Congress will truly remain confidential.

The SEC and the CFTC will be required to work together to establish the form and content of the required regulatory reports within six months after passage of the Act. Interestingly, it appears that the legislation requires regulatory reporting for each private fund, not on an aggregated fund basis per investment adviser.

Given the six month time period the SEC and CFTC has to determine the appropriate content and form of the required regulatory reports, it appears that exams conducted by the SEC under this new Act, will likely not take place until late 2010, giving newly registered investment advisers time to organize and set a books and records policy. While specifics around the five report areas were not provided in the proposed legislation, we have noted some initial implications relating to these reports. Additionally, no mention was made of how often the investment advisers will be required to file these reports.

- Assets under management: Investment advisers will need to accurately account for assets under management, taking into consideration: withdrawals, redemptions,

market movements, etc. This information is already required in Form ADV I, but will now have to be updated more frequently.

- Use of leverage (including off-balance sheet leverage): It should be noted that this topic will be controversial based on the fact that each investment adviser has its own policies relating to how they calculate and disclose their use of leverage. There are no agreed-upon standards for calculating off-balance sheet leverage obtained through derivatives and structured vehicles, and the SEC will have its work cut-out in specifying this reporting requirement.
- Counterparty credit risk exposures: This could possibly be as simple as a list of each counterparty that your firm has exposure to noting the dollar amount of that exposure.
- Trading and investment positions: An accurate and complete trade blotter would appear to satisfy this requirement; however, the format and the exact details of each investment position were not noted.
- Trading practices: This requirement is unclear. It may get into the types of trading strategies that managers employ or may also be focusing on the governance and procedures relating to a firm's trading activities.

## Disclosures and Recordkeeping

In addition to the confidential regulatory reporting, the Act's language allows for the SEC to require advisers to private funds to provide records, reports and other documents to investors, prospective investors, counterparties and creditors. This statement appears to give the SEC latitude to develop or adopt a new disclosure statement for private fund managers.

Additionally, the legislation makes clear that the SEC has authority to examine "all records of a private fund maintained by an investment adviser," not just those listed as required books and records under the Advisers Act. The intention seems to be to put to rest any legal arguments about the ability of SEC exam

teams to request records outside of the four corners of the rules.

Each investment adviser registered is required to maintain records of each private fund advised by the investment adviser for the period set forth in the rules and regulations. All records of the private funds maintained by the investment adviser are subject at any time and periodically to examinations by the SEC

### **Rulemaking Authority**

The proposed legislation also attempts to clarify the rulemaking authority of the SEC by giving the SEC the authority to define the term "client" differently as the SEC determines necessary for the different purposes of the Advisers Act.

In addition, the language disallows the ability of advisers to withhold the identity of clients and investors from the SEC. The intent seems to be to give the SEC wide discretion and authority in policing the alternatives fund industry.

### **Registration Preparation**

While the final details will be worked out over the next several months, it would appear that the SEC, the Obama Administration, Congress and the Senate have plenty of motivation to work out the details and finalize this Act by the end of 2009. This will leave investment advisers to private investment pools with the significant task of registering and bringing their compliance programs up to industry standard practice. The following are key considerations in preparing for registration:

- Prepare disclosure statement (Form ADV)
- Appoint a Chief Compliance Officer (CCO) if not already appointed.
- Adopt a formal compliance program, which includes developing policies and procedures tailored to the investment adviser's specific conflicts and risks that they face (best execution, advertising, use of third party solicitors, custody, etc.) conduct annual compliance testing, and review policies and procedures periodically.

- Adopt a written Code of Ethics that sets forth standards of conduct, policies to prevent the misuse of material non-public information, gifts and entertainment, outside business activities, political activity policies, etc.
- Develop a books and records policy to identify and maintain the business and client records.
- Ensure the compliance program has adequate and knowledgeable resources and is integrated across the key business functions, with the support of executive management.
- Establish fundamental operating committees including Investment, Brokerage/Best Execution, Valuation and Compliance/Risk Committees.

## Additional Information

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