

**CONGRESS IS ON TRACK TO PASS A COMPREHENSIVE FINANCIAL SERVICES
REGULATORY OVERHAUL BILL IN 2010 RESULTING IN INCREASED
REGULATION OF PRIVATE FUND MANAGERS**

Financial services reform in the United States took a major step toward reality on May 20, 2010 when the U.S. Senate passed its version of a comprehensive package of regulatory reforms.¹ All that is left of the long and winding road toward reform is for Congress to reconcile the Senate bill with the U.S. House of Representatives' version of the legislation passed in December 2009.² Once the Senate and House reconcile their versions of the legislation, it will be presented to President Obama for signature into law. Members of Congress participating in the reconciliation process have set a goal of having a final bill ready for the President to sign by this coming July 4.

The final version of the bill promises, among other things, to result in a significant increase in the regulation of investment advisers, in particular managers of hedge funds, private equity funds, venture capital funds, and other private funds. The provisions of the Senate and House bills that are likely to be of most direct consequence to private fund managers and other investment advisers would increase regulation of investment advisers under the Investment Advisers Act of 1940 and would potentially enhance state regulation of offerings conducted in reliance on Regulation D of the Securities Act of 1933.³

Of perhaps greater concern to some private fund managers is that they may become subject to new systemic risk regulation embedded in both the House and Senate bills. Private fund managers or private funds that are determined to be systemically important would be subject to oversight by the Federal Reserve Board of Governors under a new systemic risk regulation framework that would be established by both bills. The Senate bill also includes co-called "Volcker Rule" provisions, which could be of significant consequence to those private fund managers that are subsidiaries of a bank or a bank holding company. The Volcker Rule provisions generally would prohibit a bank, a bank holding company, and any of their subsidiaries from engaging in proprietary trading or from investing in or sponsoring hedge funds and private equity funds. The House bill does not include the full panoply of Volcker Rule provisions but instead contains a more limited provision that would permit the Federal Reserve to prohibit proprietary trading by systemically important financial companies.

¹ Restoring American Financial Stability Act of 2010, S. 3217, *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Issues.View&Issue_id=6fde36f3-f501-aaf7-42c7-af2478bc73c4.

² Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, *available at* http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/hr4173eh.pdf.

³ The investment adviser registration and regulation provisions are in Title IV of the Senate bill and Title V of the House bill. The provision in the Senate bill modifying state authority over Regulation D offerings is in Title IX, Section 926.

This Memorandum provides an overview of key provisions of the Senate bill and the House bill relating to private fund managers and describes their likely effects on private fund managers and other investment advisers.⁴ We note throughout the Memorandum instances in which the Senate and House bills contain similar provisions and those in which significant differences between the bills exist.

Increased Regulation of Private Fund Managers and Other Money Managers under the Advisers Act

The changes to the Advisers Act contemplated by both the House and Senate bills would result in many managers of private funds and other money managers that are currently exempt from registration as investment advisers with the Securities and Exchange Commission under the Advisers Act being required to so register. The bills would subject all registered investment advisers to private funds to increased recordkeeping and reporting requirements. The Senate bill and the House bill would each require an investment adviser newly subject to Advisers Act registration or to new recordkeeping and reporting requirements under the Advisers Act to comply with these requirements within one year after the enactment into law of a final bill.

Elimination and Narrowing of Existing Exemptions from Advisers Act Registration

Both the Senate bill and the House bill eliminate the “private adviser exemption” from registration under Section 203(b)(3) of the Advisers Act. That Section currently exempts a natural person or entity meeting the Advisers Act’s definition of “investment adviser” from registration under the Act if, among other things, the person or entity advised 14 or fewer clients during the preceding 12-month period.⁵ Many managers of private funds now rely on the private adviser exemption, so that its elimination would result in those managers having to register with the SEC unless they could rely on another exemption from registration.⁶ The likelihood of the managers being able to rely on another exemption is quite slim as a practical matter.

⁴ A discussion of all the areas addressed by the Senate and House financial reform bills is beyond the scope of this Memorandum. We note that the bills contain other provisions that may be of interest to financial service industry participants, including measures that: contemplate regulation of over-the-counter derivatives and market participants who trade in those derivatives; impose fiduciary duties on broker-dealers or mandate studies of existing broker-dealer regulation in the United States; add regulations designed to enhance investor protection; and establish a consumer financial protection bureau/agency.

⁵ Non-U.S. private fund managers currently are required to count only U.S. clients toward the 14-client limitation. Advisers Act Section 203(b)(3).

⁶ The private adviser exemption under Section 203(b)(3) is not the exclusive means for a money manager to avoid registration with the SEC as an investment adviser. Others include, for example, an exemption from registration provided under Section 203(b)(2) of the Advisers Act for an investment adviser whose only clients are insurance companies and an exemption from registration under Section 203(b)(4) for an investment adviser to a charitable organization.

The bills would narrow another existing exemption from registration under the Advisers Act; each would restrict the ability of a person or entity that manages a “private fund” to rely on the Act’s “intrastate exemption.”⁷ Under that exemption, a person or entity is not subject to registration under the Advisers Act if the person or entity does not provide advice regarding securities listed on a national exchange and has clients all of which are residents of the same state in which the adviser has its principal office and place of business. The bills each define the term “private fund” to mean a fund that is exempt from regulation under the Investment Company Act of 1940 by virtue of Section 3(c)(1) or 3(c)(7) of the 1940 Act. Defined in this manner, the term would include typical hedge funds, venture capital funds, and private equity funds.

The Senate bill would retain the current “CTA exemption” from registration.⁸ That exemption is available to a commodity trading advisor registered with the Commodity Futures Trading Commission whose business does not consist primarily of acting as an investment adviser (as that term is defined in the Advisers Act) and that does not advise an investment company registered with the SEC under the 1940 Act. The House bill, on the other hand, limits the availability of the CTA exemption by precluding an adviser to a private fund from relying on it.

New Exemptions from Registration under the Advisers Act

The Senate bill provides four new, generally narrow, exemptions from registration with the SEC under the Advisers Act. They are exemptions for:

- an investment adviser to one or more venture capital funds;
- an investment adviser to one or more private equity funds;
- a “foreign private adviser”; and
- an investment adviser to one or more small business investment companies.

The House bill includes each of these exemptions *except* the private equity fund adviser exemption, and contains a “*de minimis* exemption” from registration not included in the Senate bill for managers with less than \$150 million of assets under management in private funds. It is not clear how the differences in these provisions will be resolved, although some members of Congress have indicated that the private equity fund adviser exemption in the Senate bill may be eliminated. The exemptions contained in the bills provide specifically as follows:

Adviser to a venture capital fund, a private equity fund, or both. The Senate bill and the House bill would exempt from registration under the Advisers Act an investment adviser to one or more “venture capital funds,” although the bills take slightly different approaches. The House bill requires the SEC to provide by rule an exemption from registration for an investment adviser to one or more “venture capital funds” and directs the SEC to require an adviser relying on the

⁷ Advisers Act Section 203(b)(1).

⁸ Advisers Act Section 203(b)(6).

exemption to maintain records and file reports as the SEC determines is necessary or appropriate. The Senate bill, on the other hand, provides that no investment adviser may be subject to registration under the Advisers Act “with respect to the provision of investment advice relating to a venture capital fund.” Neither bill defines the term “venture capital fund.” Each bill instead directs the SEC to issue final rules defining the term “venture capital fund” (within six months of enactment of a final bill under the Senate bill and within one year under the House bill).

The Senate bill would exempt an adviser from registration “with respect to the provision of investment advice relating to a private equity fund or funds.” The SEC is directed to define the term “private equity fund” for purposes of this exemption within six months of enactment of a final bill. The SEC would have authority to prescribe records and annual reports that an adviser relying on the private equity fund adviser exemption would need to maintain and file with the SEC, and the SEC is given explicit authority to conduct examinations of such an adviser. The Senate bill appears to be intended to provide an exemption from registration for an investment adviser that manages one or more venture capital funds, private equity funds, or both types of funds; that is, the exemptions would seem to be able to be relied on concurrently.

Foreign private advisers. The Senate and House bills would each exempt from Advisers Act registration an investment adviser that meets the definition of “foreign private adviser” (called a “foreign private fund adviser” in the House bill). The bills generally define a foreign private adviser as one that:

- has no place of business in the United States; *and*
- has had fewer than 15 clients in the United States and has had aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than \$25 million (subject to increase by the SEC); *and*
- does not hold itself out generally to the public in the United States as an investment adviser or act as an investment adviser to a 1940 Act-registered investment company.

A foreign private adviser would be required to include in calculating its assets under management for the purpose of the exemption those assets attributable both to U.S. clients and U.S. investors in private funds managed by the adviser. Unlike the exemption in the Senate bill, the House bill’s exemption would require an adviser that wishes to rely on the exemption to count the number of its clients and investors and its aggregate assets under management on a 12-month rolling basis; counting in this manner is similar to the client-counting mechanism under the current private adviser exemption set out in Section 203(b)(3) of the Advisers Act. The Senate bill does not require an adviser to count clients or investors or its assets under management on a rolling basis. In seeking to rely on the exemption in the Senate bill, an adviser would instead be required to have fewer than 15 U.S. clients and less than \$25 million of assets under management attributable to U.S. clients or investors at any time.

Adviser to small business investment companies. Under both the Senate and House bills, an investment adviser to a “small business investment company” licensed under the Small Business Investment Act of 1958 could rely on a new statutory exemption from registration as an investment adviser under the Advisers Act. The exemption would be available to an investment adviser whose business is limited to managing one or more SBICs. An SBIC for purposes of the bills includes: a small business investment company that is a licensee under the SBIA; an entity that has received from the Small Business Administration notice to proceed to qualify for a license as a small business investment company under the SBIA, which notice or license has not been revoked; or an entity with a pending application for a license under the SBIA that is affiliated with one or more licensed small business investment companies.

De minimis exemption. The House bill includes an exemption from registration that would be available to an investment adviser that manages one or more private funds *and* has assets under management in the United States of less than \$150 million. This “*de minimis* exemption” appears to be unavailable for an investment adviser that provides advice to any client that is not a private fund, even if the adviser has less than \$150 million of assets under management. The Senate bill does not contain a similar provision.

Additional Reporting and Recordkeeping Requirements for Registered Investment Advisers to Private Funds

The bills each impose new reporting and recordkeeping requirements on SEC-registered investment advisers to private funds. Under the bills, such an adviser would need to maintain and make available for SEC inspection records and file reports for each private fund it manages. The records and reports contemplated by the bills are not the same. We believe it likely that the records and reports required would include for each private fund managed by an adviser a description of:

- side arrangements or side letters;
- trading and investment positions;
- amount of assets under management and use of leverage;
- counterparty credit risk exposures;
- trading practices;
- valuation policies and practices;
- the types of assets held; and
- other information as deemed appropriate by the SEC in consultation with systemic risk regulators.

The SEC would be expressly authorized to require a registered investment adviser to file with the SEC additional reports regarding a private fund it manages “as are necessary or appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk.” In addition, *all* records of a private fund, not just those required to be maintained, would be subject to SEC examination authority.

Family Offices

The Senate bill, but not the House bill, would authorize the SEC by “rule, regulation, or order” to exempt a “family office” from the definition of “investment adviser” under the Advisers Act. The bill requires that any such rule, regulation, or order be consistent with the SEC’s previous exemptive policy with respect to family offices and the Advisers Act. The SEC has in the past provided exemptive orders to family offices—albeit at an oftentimes glacial pace—taking the position that under certain circumstances, a family office does not fall within the definition of investment adviser under Section 202(a)(11) of the Advisers Act. The text of the Senate bill would not expressly exempt all family offices from the Advisers Act and does not require the SEC to issue any such exemptions, so it is unclear whether the provision would lead to the SEC’s providing additional Advisers Act exemptive relief generally to family offices. The SEC could instead continue its current practice of exempting family offices on a case-by-case basis.

Increased Threshold for SEC Registration

Both the Senate and House bills would increase the threshold for registration as an investment adviser with the SEC under Section 203A of the Advisers Act from \$25 million to \$100 million of assets under management. Advisers with less than \$100 million of assets under management may be required to register with individual states. The House bill would permit an investment adviser with less than \$100 million, but more than \$25 million, of assets under management to register with the SEC if the adviser would be required to register with five or more states. The increased threshold contemplated by the Senate and House bills could dramatically reduce the number of investment advisers currently registered with the SEC under the Advisers Act.

State Authority over Regulation D Offerings

The Senate bill includes a provision that would result in enhanced state regulation of offerings made in reliance on Regulation D under the Securities Act. These offerings generally enjoy federal preemption under current law. The Senate bill directs the SEC by rule to permit state regulation of a Regulation D offering by a person convicted of a felony or misdemeanor in connection with the sale or purchase of a security or who is subject to certain types of final orders issued by a state securities commission or other state financial regulator. The types of orders that could result in an offering’s being subject to enhanced state regulation include those that:

- bar a person from:
 - associating with an entity regulated by a state securities commission or state financial regulator;
 - engaging in the business of securities, insurance, or banking; or
 - engaging in savings association or credit union activities; or
- constitute a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of the filing of the offering statement.

It is not clear whether this provision would apply only to an issuer making an offering under Regulation D or would extend to officers, directors, owners, or other persons associated with the issuer. The SEC would be directed to issue rules to implement this provision within one year of enactment of a final bill. The House bill contains no similar provision and would not result in any change to the state authority over Regulation D offerings.

Systemic Risk and “Volcker Rule” Provisions

The Senate and House bills each contains provisions designed to address systemic risk concerns thought to be posed by financial institutions and to prevent the existence of financial institutions that are “too big to fail.” The bills would each establish a council of regulators—termed the “Financial Stability Oversight Council” in the Senate bill and the “Financial Services Oversight Council” in the House bill—that would have general systemic risk oversight authority over the financial services industry. Both bills would provide new authority for the Federal Deposit Insurance Corporation to act as receiver for failing financial firms that are subject to heightened systemic risk regulation. The Senate bill would, as discussed above, also implement “Volcker Rule” provisions, which, among other things, would prohibit banks, banking holding companies, and their subsidiaries from engaging in proprietary trading and investing in or sponsoring hedge funds and venture capital funds. The House bill includes only a more limited restriction on proprietary trading.

Oversight Council for Systemic Risk Regulation

The Senate bill creates a Financial Stability Oversight Council that could designate a nonbank financial company as subject to supervision by the Federal Reserve if the Council “determines that material financial distress of [the company] would pose a threat to the financial stability of the United States.” A “nonbank financial company” as defined in the bill could include an investment adviser or a hedge fund, private equity fund, mutual fund, or other investment fund. Under the bill, the Federal Reserve would be given general systemic risk oversight responsibilities for “large, interconnected” bank holding companies that have \$50 billion or more in assets.

The House bill similarly would give the Financial Services Oversight Council authority to subject any “financial company” to increased systemic risk regulation. These regulations would be developed by the Federal Reserve in consultation with a financial company’s primary federal regulator. The Senate bill does not require such consultation. Under the House bill’s definition of “financial company,” as is the case under the Senate bill, an investment adviser or an investment fund—as well as a bank or a bank holding company—could be subject to heightened regulation. Unlike the Senate provision, the House provision does not specify a minimum asset threshold that a bank holding company must meet to be subject to heightened regulatory standards.

Under both bills, the Federal Reserve would have authority to impose various requirements on companies subject to increased systemic risk regulation. These requirements could include meeting minimum capital requirements, leverage limits, liquidity requirements, concentration limits, and general risk management requirements.

Federal Deposit Insurance Corporation Liquidation Authority

Both the Senate and House bills would provide the FDIC and the Federal Reserve authority to determine that a systemically relevant financial company is failing and should be placed into liquidation. That determination would be made on the basis of criteria relating to the financial health of and systemic risk posed by the company. Under the Senate bill, an SEC vote would be required for a broker-dealer registered with the SEC to be placed into involuntary liquidation.

“Volcker Rule” Reforms; Restrictions on Proprietary Trading

The Senate bill contains provisions, generally referred to as the “Volcker Rule,” that would require federal banking regulators to issue rules to prohibit a bank, a bank holding company, and their subsidiaries from engaging in proprietary trading and from sponsoring or investing in hedge funds and private equity funds. An asset management firm that is a subsidiary of a bank or bank holding company would be subject to these prohibitions. The Volcker Rule provisions would be subject to a two-year implementation period, which could be extended up to three additional years at the discretion of federal banking regulators.

The Senate bill defines the term “proprietary trading” to include “purchasing or selling, or otherwise acquiring and disposing of” financial instruments by a bank, bank holding company, or any of their subsidiaries for “the trading book of [the company or subsidiary].” Certain types of trading, including trading for a customer or trading in U.S. government securities, are exempted from the proprietary trading prohibition. The term “sponsoring” is defined broadly with respect to sponsoring a hedge fund or private equity fund to include: serving as a general partner, managing member, or trustee of a fund; selecting or controlling a majority of the fund’s directors, trustees, or management; or sharing the same name or variation of the same name as the fund. The terms “hedge fund” and “private equity fund” are each defined for purposes of the prohibition as an entity that is exempt from the definition of investment company under the 1940 Act in reliance on Section 3(c)(1) or 3(c)(7) of that Act. The Volcker Rule provisions, unlike the Senate bill and the House bill definitions of “private fund,” however, would permit federal banking regulators to include other entities in the definition of hedge fund and private equity fund as they find appropriate.

The Volcker Rule provisions include several other restrictions for financial institutions. The provisions enable the Federal Reserve to place capital requirements and quantitative limits on a nonbank financial company (*e.g.*, a hedge fund or a hedge fund manager) supervised by the Federal Reserve. A bank, bank holding company, or any of their subsidiaries that are supervised by the Federal Reserve would be prohibited from engaging in certain transactions with a hedge fund or private equity fund for which the company serves directly or indirectly as investment adviser.

The House bill does not include the full set of Volcker Rule provisions contained in the Senate bill, but provides the Federal Reserve the authority to prohibit a “financial holding company” that the Financial Services Oversight Council has designated to be subject to heightened systemic risk regulation from engaging in proprietary trading. The Federal Reserve can exercise this

authority if it makes a determination that the financial holding company “poses an existing or foreseeable threat to the safety and soundness of such company or to the financial stability of the United States.” The term “financial holding company” as defined by the House bill could include an investment adviser or an investment fund.

Next Steps for Managers of Private Funds and Other Investment Advisers

Congress appears headed towards a relatively quick reconciliation process, and it seems likely that a final financial services reform bill will be enacted this summer. The provisions of the House and Senate bill discussed in this Memorandum may be modified during the reconciliation process, but we understand from Congressional insiders that the general framework for these provisions is not likely to change.

Investment advisers that become subject to registration or reporting and recordkeeping requirements under the Advisers Act as a result of the legislation would under both the House and Senate bills have a one-year period following enactment of a final bill within which to comply—which could mean having to comply as early as the summer of 2011. An adviser that could face the new requirements or new systemic risk-related regulation may wish to begin considering in the near term steps to address them. We stand ready to assist with this process. We also will continue to monitor and report on developments relating to this legislation as well as on any other regulatory and legislative initiatives relating to financial reform that are considered in the future by the U.S. Congress, legislatures of countries other than the United States, and financial regulatory agencies throughout the world.

* * * * *

If you have any questions concerning the matters described in this Memorandum, please contact Barry Barbash (202-303-1201, bbarbash@willkie.com); Russell L. Smith (202-303-1116; rsmith@willkie.com); David W. Blass (202-303-1114, dblass@willkie.com); Jai Massari (202-303-1133, jmassari@willkie.com); or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, DC telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

June 3, 2010

Copyright © 2010 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This Memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This Memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York’s Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.