Private Funds Registration Nears Reality

By: Paul Brook, Partner
Compliance Solutions Associates

It is not much of a stretch to think that the headlines reading "SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme" and "New SEC Complaint Says Stanford Ran Ponzi Scheme" led to this headline: "SEC Accuses Goldman of Fraud in Housing Deal." Embattled but retooled, the Securities and Exchange Commission, armed with a $1.3 billion budget (as proposed) and new proposed legislation expanding its purview, is ready to regulate like it never has before. With this as a backdrop, investment advisers registered with the SEC better be dotting their i's and crossing their t's.

President Barack Obama has requested a 12% increase in the SEC's budget for the upcoming year which would enable it to hire 374 more employees. We are likely to see an SEC that is less tolerant and forgiving than in the past and is likely to err on the side of caution. With financial reform high on President Obama's list of priorities and next on his agenda, this article will review the status of the current legislation requiring investment advisers of private funds to register with the SEC, discuss the differences between the House and Senate versions and identify some of the issues that newly registered advisers will face. While this article will highlight some of the provisions contained in both bills, it is not an exhaustive discussion of all the provisions of the bills and reference to the bills themselves should supplement this reading.

As of this writing, the Senate version is being debated along party lines so far. But this appears to be posturing for a compromise which is expected. The House passed its version late last year. Both bills provide for an effective date of one year from passage for most of the provisions, so the effect of the bill, whenever it becomes law will not be until 2011 at the earliest.

Where the Senate and House Agree

The key provisions of both bills are very similar and in some cases the wording is identical. Both bills require that "private funds" register with the SEC by excluding them from the exemptions from registration in the Investment Advisers Act of 1940 ("Advisers Act"). Both define a private fund, which will reel in many, if not most, hedge funds into the definition. Basically, a private fund is a fund that would be required to be registered under the Investment Company Act of 1940 ("1940 Act") but for the Section 3(c)(1) and 3(c)(7) exemptions. Therefore, while hedge funds still will not have to register under the 1940 Act, their advisers will now have to register under the Advisers Act, unless the adviser meets one of the new more restrictive exemptions under the Advisers Act discussed below.

Both bills provide exemptions from registration under the Advisers Act for foreign private fund advisers. A foreign private fund adviser is an adviser with no place of business in the United States, fewer than 15 clients in the U. S. **and** less than $25 million of assets under management attributable to clients in the U. S. There are fewer registration exemptions for foreign private fund advisers than for domestic private fund advisers.

Both bills also exempt venture capital fund advisers and require the SEC to fashion a definition of a venture capital fund.

Both bills have additional recordkeeping requirements that require maintenance of records that include a description of:

- The amount of assets under management,
- The use of leverage,
- Counterparty credit risk exposure,
- Trading and investment positions, and
- Trading practices.

In addition, the Senate version requires the following additional records to be maintained:

- Valuation policies and practices,
- Types of assets held, and
- Side arrangements or side letters, whereby certain investors obtain more favorable rights than other investors.

Both bills give the SEC latitude to define the term "client" except that the SEC may not define the term "client" to include an investor in a private fund managed by an adviser if such private fund has entered into an advisory contract with the adviser.

Finally, both bills call for the SEC to conduct periodic and special examinations of the private funds managed by a registered investment adviser.

<u>Where the Senate and House Disagree</u>

The Senate version includes several provisions that the House version does not. In addition, they include differences in a couple of key areas.

First, both bills provide for exemption from registration if assets under management are below a certain threshold, but include different thresholds. The Senate bill provides an exemption for advisers with less than $100 million of total assets under management. The Senate version simply changes the amount in the Advisers Act that discussed exemption based on assets (Section 203A(a)(1)(A)) from $25 million to $100 million.

The House version adds a paragraph that exempts advisers of private funds, if the adviser acts *solely* as an adviser to private funds and has assets under management of less than $150 million. An earlier version of the House bill exempted advisers if *each* private fund it advised had less than $150 million of assets under management. This would have allowed an adviser to manage an unlimited number of private funds and not register as long as each private fund's assets were less than $150 million. By not changing Section 203A(a)(1)(A), the House version appears to require registration if an adviser has more than $25 million of assets under management that are not defined as "private funds." It also appears that registration may be required if non "private fund" assets were below the $25 million threshold, but "private fund" assets pushed the total

above $25 million since the $150 million exemption is only available if the adviser acts *solely* as an adviser to private funds.

A second key difference is the treatment of "private equity funds." The Senate version exempts advisers of private equity funds. It calls for the SEC to provide a definition of a "private equity fund," and to also to prescribe records and reports to be maintained and/or filed with the SEC by the adviser to the private equity fund. The House version does not mention private equity funds, so it would appear that they could only be exempted under the other provisions.

Other differences in the two bills include:

- The Senate version requires the SEC to make an annual report to Congress describing how the SEC has used the data collected to monitor the markets for the protection of investors and the integrity of the markets.
- The Senate version specifically exempts family offices, while the House version is silent. Family offices have previously been deemed exempt but only through an exemptive relief process.
- The Senate version requires the SEC by rule to increase the income and asset threshold in the definition of an "accredited investor" now and no less frequently than every five years going forward. The House version has a generic requirement to adjust any factors or tests that use dollar thresholds for inflation every five years.
- Both versions require studies by the Comptroller General on topics such as the feasibility of a self-regulatory organization to oversee private funds (Senate version), and the annual costs of adviser registration and regulation on advisers and their investors (House version).

What's An Adviser To Do?

If an adviser will be required to register with the SEC under the final legislation, it will have significant recordkeeping, reporting and compliance responsibilities. Among them would be the designation of a Chief Compliance Officer ("CCO"), and the creation of compliance procedures, manuals and supplemental checklists. While many of the latter may already be in place, the CCO may be the biggest expense item. Depending on the size and complexity of the adviser and its operations, the adviser may be able to designate someone internally to handle the CCO duties, may have to hire a full-time CCO or may decide to outsource the function to a consulting firm. The cost for a CCO will vary according to level of experience needed but will likely run well into the mid-six figures for a competent CCO plus support staff.

The Congressional Budget Office ("CBO") prepared a cost estimate for enactment of the House version of the legislation. It estimates that 1,300 advisers will have to register with the SEC with an estimated cost to prepare for the registration process of less than $30,000 per firm. The CBO did not provide an estimate for the ongoing costs except noting that it did not expect those costs to be significant. However, the CBO did not mention the CCO function or potentials costs, nor did it define what it deems to be "significant."

While many advisers will have to register with the SEC for the first time, based on the increase in the exemption thresholds noted in each bill, it is estimated that the number of overall advisers

registered with the SEC will decrease significantly. Those advisers will then be required to register with the states within which they do business. So while they will be able to eliminate certain costs, they will have additional ones with respect to the states that require filing.

Those advisers that must register with the SEC for the first time should prepare for and expect an early visit from the SEC. The SEC is ramping up staff and process, and will be looking to make examples. What if you no longer need to register with the SEC or never did and still do not? Well, you won't be subject to SEC oversight, however, given today's environment and the proliferation of embarrassing headlines, you would be well advised to take a good look at your procedures. And be ready for new and existing clients to vet you with added zeal. It may make sense to have a compliance function that you can point to when potential investors inquire about protection against Ponzi schemes, fraud and other nefarious events. If you are not up to standards and best practices, your business may be at risk.

Paul Brook, CPA, MBA is a Partner at Compliance Solutions Associates, specializing in providing an outsource solution to the Chief Compliance Officer role as well as other business and compliance consulting services to the asset management industry. Paul can be reached at pabrook@csacompliance.com