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REPORT

REGULATORY REFORM

An Examination of the Private Equity Proposals in the Senate Reform Bill

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I. Introduction

Several proposals were introduced in 2009 and 2010 that seek to regulate exempt investment advisers and private investment companies more closely. On March 15, 2010, Senator Christopher Dodd (D-CT) introduced a proposed omnibus financial regulation package entitled ''The Restoring American Financial Stability Act of 2010'' as amended by certain amendments thereto (''Senate Bill''), which contains several portions that are relevant to private equity. The Senate Bill is similar in several respects to the proposed ''The Wall Street Reform and Consumer Protection Act of 2009'' introduced by Representative Barney Frank (D-MA) and passed by the House of Representatives on December 11, 2009 (''House Bill''). The Senate Bill was recently passed by the Senate on May 20, 2010.

This article primarily discusses the provisions of the House Bill and the Senate Bill that are relevant to advisers' registration and related matters. This article also discusses the proposed provisions of the Senate Bill that would impact the relationship between banks and private equity funds.

We note that the House Bill would contain in Section 7001, et seq., the Investor Protection Act. We do not discuss the Investor Protection Act in this article, since it did not appear in the Senate Bill. The Investor Protection Act sought to improve all four main bodies of the securities laws to protect investors. For the most part, it focused on investment advisers and broker-dealers. This article also does not discuss proposed changes to public company executive compensation, which could affect portfolio companies of private equity funds.

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Moreover, this article does not discuss proposed revisions to tax law that could affect private equity funds.

The ultimate legislation that is enacted will likely reflect portions of the House Bill and the Senate Bill, which is why we have discussed the House Bill as well as the Senate Bill. The primary difference between the House Bill and the Senate Bill is that the House Bill focuses on protecting investors, while the Senate Bill focuses on systemic risks that may affect the integrity of the markets.

II. Senate Bill Highlights

(1) Adviser Registration and Exemptions

(A) Section 203(b)(1): The Intrastate Advisers Exemption

Section 203(b)(1) currently exempts from registration any investment adviser all of whose clients are residents of the state within which such investment adviser maintains its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange.

Under the House Bill, investment advisers that advise ''private funds'' would not be able to rely upon the exemption in Section 203(b)(1) of the Advisers Act.[1] ''Private funds'' would include an investment fund that would be an investment company but for the exemptions in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (''Investment Company Act''). The definition of an ''investment company'' is beyond the scope of this article, but would generally include most types of funds that invest more than 40% of their total assets in securities on an unconsolidated basis.[2] The Senate Bill would contain a similar provision.[3] Since Section 3(c)(1) and Section 3(c)(7) are the most common Investment Company Act exemptions used by private equity funds, most private equity funds would be unable to use the intrastate exemption under either the House Bill or the Senate Bill.

Under the Senate Bill, as under the House Bill, investment advisers that solely advised private equity real estate funds solely relying upon Section 3(c)(5)(C) and other private equity funds solely relying on Investment Company Act exemptions other than Section 3(c)(1) and Section 3(c)(7) would continue to be able to rely upon Section 203(b)(1) of the Advisers Act.

(B) Section 203(b)(3): The Fewer than 15 Clients Exemption

Section 203(b)(3) currently exempts investment advisers who advise non-registered funds who during the course of the preceding 12 months had fewer than 15 clients and who do not hold themselves out to the public as investment advisers.

The Senate Bill would strike Section 203(b)(3) in its entirety and replace it with a provision that would provide that the Advisers Act would not apply to ''any investment adviser that is a foreign private adviser.''[4] The term ''foreign private adviser'' would mean any investment adviser who:

(A) has no place of business in the United States;

(B) has, in total, fewer than 15 clients in total who are domiciled in or residents of the United States;

(C) has 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 $25,000,000, or such higher amount as the Commission may, by rule, deem appropriate in accordance with the purposes of this title; and

(D) neither –

(i)holds itself out generally to the public in the United States as an investment adviser; nor

(ii) acts as –

(I) an investment adviser to any investment company registered under the Investment Company Act of 1940; or

(II) a company that has elected to be a business development company pursuant to section 54 of the Investment Company Act of 1940, and has not withdrawn its election.

The definition of ''foreign private adviser'' is similar to the definition thereof in the House Bill,[5] except that (i) the Senate Bill provides for fewer than 15 clients, in total, not just over the preceding 12 months and (ii) the Senate Bill refers to ''aggregate'' assets under management, not aggregate assets under management during the preceding 12 months. Thus, in this respect, the Senate Bill is somewhat more limited in terms of exempting foreign private advisers.[6]

The Securities and Exchange Commission (''SEC'' or ''Commission'') has in the past recognized the separateness of a foreign affiliate of a U.S. investment adviser if: (1) the affiliated companies are separately organized (e.g., two distinct entities); (2) the U.S. entity is staffed with personnel (located in the U.S. or abroad) who are capable of providing investment advice; (3) all persons involved in U.S. advisory activities are deemed ''associated persons'' of the U.S. entity; and (4) the SEC has adequate access to trading and other records of each affiliate involved in U.S. advisory activities and to its personnel, to the extent necessary to monitor and police conduct that may harm U.S. clients or markets.[7] The Commission also requires that for *all* transactions (i.e., whether involving U.S. clients or not) the affiliates maintain the books and records described in Rules 204-2(a)(1), (2), (4), (5), and (6) and 204-2(c) (i.e., basic financial books and records). For transactions involving U.S. clients and related transactions, the affiliates are also required to retain the records described in Rule 204-2(a)(3) and (7) (i.e., information on specific securities transactions and recommendations) as well as the trading records required by Rule 204-2(a)(12) for ''advisory representatives'' involved in giving advice to U.S. clients.[8] We anticipate that the Commission would probably continue to recognize similar criteria in determining the separateness of a foreign affiliate of a U.S.

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[1] House Bill, Section 5003.
[2] Section 3(a)(1)(C), Investment Company Act.
[3] Senate Bill, Section 403.
[4] Senate Bill, Section 403.

[5] House Bill, Section 5002.
[6] We note that with respect to either the House Bill or the Senate Bill, the interaction of the foreign private adviser exemption must be viewed in light of Section 208(d) of the Advisers Act, which prohibits doing indirectly what cannot be done directly.
[7] Uniao de Bancos de Brasileiros S.A., SEC No-Action Letter, 1992 WL 183054, Fed. Sec. L. Rep. (CCH) ¶ 76,425 (July 28, 1992).
[8] Thomas P. Lemke and Gerald T. Lins, Regulation of Investment Advisers, § 1:42.

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investment adviser with respect to the foreign private adviser exemption.

(C) Section 203(b)(6): The CFTC Exemption

Section 203(b)(6) currently exempts investment advisers that are registered with the Commodity Futures Trading Commission (CFTC) as a commodity trading advisor whose business does not consist primarily of acting as an investment adviser as defined in Section 202(a)(11) and that does not act as an investment adviser to (A) registered investment companies; and (B) any company that has elected to be a business development company and has not withdrawn its election. The House Bill would additionally disallow the use of Section 203(b)(6) if the investment adviser acts as an investment adviser to ''private funds.'' The Senate Bill does not contain a similar provision.

(D) The SBIA Exemption

The Senate Bill would add a new investment adviser exemption in proposed Section 203(b)(7).[9] Section 203(b)(7) would provide that Advisers Act registration would not apply with respect to ''any investment adviser, other than an entity that has elected to be regulated or is regulated as a business development company pursuant to section 54 of the Investment Company Act of 1940, who solely advises –

(A) small business investment companies that are licensees under the Small Business Investment Act of 1958;

(B) entities that have received from the Small Business Administration notice to proceed to qualify for a license as a small business investment company under the Small Business Investment Act of 1958, which notice or license has not been revoked; or

(C) applicants that are affiliated with 1 or more licensed small business investment companies described in subparagraph (A) and that have applied for another license under the Small Business Investment Act of 1958, which application remains pending.''

The House Bill contains a substantially similar provision,[10] except that under the House Bill investment advisers who solely advise (A), (B) and (C) above may qualify for the exemption even if they have elected to be regulated or are regulated as a business development company.

Under the Senate Bill, an exempt SBIA fund manager may be subject to registration if it manages funds or accounts that are not exempt under the Advisers Act. Furthermore, the Senate Bill does not explain how the SBIA exemption would apply with respect to SBIA investment advisers who have affiliates that engage in advisory activities that are not exempt under the Advisers Act.

We note that small business investment companies are subject to relatively strict regulations under the Small Business Investment Act. The House Bill and the Senate Bill could make use of small business investment companies more attractive for certain investment advisers, who would be able to obtain an exemption from Advisers Act registration on that basis.

(E) The Venture Capital Exemption

The House Bill would provide that there would be a ''venture capital fund'' exemption for investment advisers that advise venture capital funds (excluding any adviser who would be exempt from registration pursuant to Section 203(b)(7), the small business investment companies exemption). However, the SEC would have the authority to require such advisers to maintain records and provide reporting to the SEC as it determines is necessary or appropriate in the public interest or for the protection of investors.[11]

The Senate Bill would add a new exemption to Section 203 of the Advisers Act that would provide that ''no investment adviser shall be subject to the registration requirements [of the Advisers Act] with respect to the provision of investment advice relating to a venture capital fund.''[12] As a result, an exempt venture capital fund manager may be subject to registration if it manages funds or accounts that are not exempt under the Advisers Act. Furthermore, the Senate Bill does not explain how the venture capital exemption would apply with respect to venture capital investment advisers who have affiliates that engage in advisory activities that are not exempt under the Advisers Act.

The Senate Bill does not define what is a ''venture capital fund,'' but leaves that determination to future Commission rules. Unlike the House Bill, the Senate Bill would not give the SEC the authority to require records and reporting for venture capital exempt funds.

(F) The Private Equity Exemption

Unlike the House Bill, the Senate Bill would add an additional new exemption to Section 203 of the Advisers Act which provides that, absent certain unspecified exceptions, ''no investment adviser shall be subject to the registration or reporting requirements of [the Advisers Act] with respect to the provision of investment advice relating to a private equity fund or funds.''[13] As a result, an exempt private equity fund manager may be subject to registration if it manages funds or accounts that are not exempt under the Advisers Act. Furthermore, the Senate Bill does not explain how the private equity exemption would apply with respect to private equity investment advisers who have affiliates that engage in advisory activities that are not exempt under the Advisers Act.

The Senate Bill does not define what is a ''private equity fund,'' but leaves that determination to future Commission rules. The Senate Report accompanying the Senate Bill indicates that ''private equity funds'' are expected to have the following characteristics: (1) limited or no fund leverage; (2) no redemption rights; (3) investments consisting of long-term investments of equity capital; and (4) not invested in securities characteristic of a hedge fund. However, the SEC would have authority to define ''private equity funds'' in a manner which raises systemic risk concerns. It is unclear whether a person who manages funds of funds, real estate funds, debt funds or certain other closed end funds would qualify for this exemption.[14]

The reason for permitting investment advisers advising private equity and venture capital funds to be exempt from registration is a recognition that most of the alleged abuses in the fund context have occurred in the hedge fund context, rather than the private equity and venture capital context. The Report accompanying the Senate Bill explains why venture capital funds and private equity funds do not pose systemic risk issues.

[9] Senate Bill, Section 403.
[10] House Bill, Section 5003.
[11] House Bill, Section 5006.
[12] Senate Bill, Section 407.
[13] Senate Bill, Section 408.
[14] KirklandPen, Private Equity Newsletter (May 25, 2010).

The Senate Bill would also require the Commission to issue rules to require investment advisers exempt under the private equity exemption to maintain records and provide the Commission with annual or other reports as the Commission, taking into account fund size, governance, investment strategy, risk and other factors, determines necessary and appropriate in the public interest and for the protection of investors.[15] This leaves open the possibility that the Commission would allow a hedge fund exemption under the private equity exemption, but would choose to require heightened record and reporting requirements for those funds.

(G) Family Offices

The Senate Bill would add a new exclusion from the definition of ''investment adviser'' in Section 202(a)(11) that would apply to any family offices as defined by rule, regulation or order of the Commission,[16] also reflecting the policy intent that family offices are not as problematic from a regulatory perspective as hedge funds. The Senate Report notes that the rules shall provide for an exemption that is consistent with the SEC's previous exemptive policy and that takes into account the range of organizational and employment structures employed by family offices. The House Bill did not contain such an exemption.

(H) Scaled Registrations

Under the House Bill, the SEC would scale registration requirements by rules according to the relative risk profile of different classes of private funds.[17] In addition, the SEC would be obligated to take into account the size, governance and investment strategy of funds to determine whether they pose systemic risk, and to provide for registration and examination procedures with respect to the investment advisers of such funds which reflect the level of systemic risk posed by such funds.[18]

The Senate Bill does not have a provision that provides for scaled registration, but would effectively scale registration based on the likely systemic risk of the investment adviser. For example, hedge funds would likely be subject to registration. Private equity funds would not be subject to registration, but could be subject to heightened record keeping and reporting requirements. Finally, venture capital funds would neither be subject to registration nor heightened record keeping and reporting requirements.

(2) Asset Threshold for Federal Registration of Investment Advisers

Currently, under Rule 203A-1, investment advisers subject to state registration are (1) not permitted to register with the Commission unless the investment adviser (A) has assets under management of not less than \$ 25 million; or (B) is an adviser to a registered investment company; and (2) not required to register with the Commission unless the investment adviser (A) has \$30 million in assets under management; or (B) is an adviser to a registered investment company.

Under the House Bill, investment advisers that act solely as an adviser to private funds and that have assets under management in the U.S. of less than \$150 million would be exempt from registration.[19] The House Bill would therefore raise the threshold for required registrations from \$30 million to \$150 million, which likely reflects a Congressional policy that only larger investment advisers that generate systemic risks should be regulated by the SEC. Unlike the Senate Bill, the House Bill does not recognize that private equity funds may pose less systemic risk. Under the Senate Bill, the SEC would require such exempt advisers to maintain records and provide reporting to the SEC as it determines necessary or appropriate in the public interest or for the protection of investors.[20] The House Bill's record keeping and reporting requirements do not take into account that certain types of funds may not be as likely to create systemic risk.

The Senate Bill would raise the floor for federal registration for such advisers from \$25 million to \$100 million,[21] but does not provide details regarding whether the floor would also be the mandatory threshold for advisers registration under Rule 203A-1. Smaller investment advisers would generally still have to register under applicable state law.

The Senate Bill would also allow registration for investment advisers that are advisers to a company that has elected to be a business development company pursuant to section 54 of the Investment Company Act and that has not withdrawn its election, notwithstanding falling short of the above \$100 million threshold.[22]

(3) Policy Considerations of Investment Adviser Registration

(A) Consequences of Registration

Registration would subject applicable investment advisers to the full scope of the Advisers Act, including, without limitation, its custody and record keeping requirements. Advisers that are currently exempt under the Advisers Act are only subject to a few requirements, such as the antifraud and supervision requirements. In addition, as the Senate Report notes, registration of investment advisers will allow the SEC to undertake examinations and bring enforcement proceedings, and levy fines and penalties, against the newly registered investment advisers.

(B) Section 203(b)(1) Exemption

The Senate Bill would seek to narrow the Section 203(b)(1) exemption applicable to intrastate investment advisers, but would simultaneously raise the floor on federal registration to \$100 million and would add an additional private equity exemption. This would likely reflect a policy that large intrastate hedge fund investment advisers are appropriate subjects of federal registration when they generate systemic risk. The \$100 million floor is important because only larger investment advisers are likely to generate systemic risks. In addition, the Senate Bill recognizes that private equity funds, as opposed to hedge funds, likely do not generate systemic risks. For example, the EU recently postulated that only hedge funds give rise to macroprudential economic risk.[23] The Senate Report also adopts this view.

One problem of narrowing the Section 203(b)(1) exemption is that many purely intrastate investment ad-

[15] Senate Bill, Section 408.
[16] Senate Bill, Section 409.
[17] House Bill, Section 5003.
[18] House Bill, Section 5007.
[19] House Bill, Section 5007.
[20] House Bill, Section 5007.
[21] Senate Bill, Section 410.
[22] Senate Bill, Section 410.
[23] See Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC.

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visers, which are typically smaller in size than interstate advisers, would likely fall short of the assets under management threshold for federal registration, particularly if the Senate Bill raises the floor on federal registration from $25 million to $100 million. Thus, even if such advisers were not exempt under Section 203(b)(1), they would likely be unable to register under federal law. It is therefore doubtful whether narrowing Section 203(b)(1) would protect investors under federal law.

Another problem with narrowing the intrastate exemption is that it would seem that the states would be in a better position to regulate purely intrastate investment advisers than the SEC, since there would not be any issues regarding a myriad of separate state regulations. Moreover, the Senate Report recognized that state regulation is effective, which raises questions as to why the intrastate exemption should be narrowed. ''States have developed an effective regulatory structure and enhanced technology to oversee investment advisers.''[24] Before enacting the revisions to the intrastate exemption under the Advisers Act, Congress should consider the effectiveness of state regulation as well as the fact that intrastate advisers are unlikely to generate systemic risks.

(C) Section 203(b)(3) Exemption

All of the adviser registration proposals have considered narrowing Section 203(b)(3) of the Advisers Act in one form or another. Section 203(b)(3) is the core investment adviser exemption that is relied upon by most private equity and hedge fund investment advisers who advise Section 3(c)(1) and Section 3(c)(7) exempt funds. The Senate Bill attempts to narrow Section 203(b)(3), but would, as discussed above, raise the floor on federal registration to $100 million and would add an additional private equity exemption, thereby, for the reasons discussed above, providing a carve-out from regulation when there are not systemic risks present.

The Senate Bill would effectively require hedge fund investment advisers to register if they generate systemic risks. Private equity fund investment advisers, which give rise to a lesser degree of systemic risk, under the Senate Bill, would not have to register, but would be subject to heightened record keeping and reporting requirements. Venture capital fund investment advisers, which give rise to less systemic risk, would neither have to register nor be subject to heightened record keeping and reporting requirements.

The House Bill, although it does not contain an exemption for private equity funds, would allow the SEC to scale registration requirements by rules according to the relative risk profile of different classes of private funds.[25] The Senate Bill would provide more clear guidance on how those registration requirements should be scaled. In particular, the Senate Bill would more precisely focus increased registration requirements on investment advisers that were likely to generate systemic risks, instead of, as would be the case under the House Bill, ''risk profile[s]'' more generally.

The Senate Bill's approach seems to make logical sense, even though it does not address the protection of smaller investors to the same extent as the House Bill, since smaller investors can presumably be adequately protected under state law, which is in many cases as strict as federal law. In addition, investment advisers not registered with the SEC usually must register under state law regimes. Congress will need to consider whether state law can adequately protect investors. The Senate Report notes the effectiveness of the state adviser regulation system, as discussed above. If state law can adequately protect smaller investors, then it would seem that the public interest of a revised federal regulation would focus on systemic risks, rather than risks in general. Before enacting final regulations, Congress should ascertain the effectiveness of state regulation and understand the systemic risks posed by the different types and classes of fund investment advisers.

(D) The Adviser's Perspective

From the investment adviser's perspective, narrowing Section 203(b)(1) or Section 203(b)(3) will generally shift the adviser's regulatory compliance burden from state law to federal law. Most states subject investment advisers not registered with the SEC to significant state law regulatory regimes, which usually includes some form of registration on Form ADV and which also usually contains all or many of the requirements of the federal regime for registered advisers.

One could argue from the investment adviser's perspective that a federal regime would be simpler due to the fact that the investment adviser would not have to wrestle with an array of state laws, particularly for larger investment advisers who undertook business in many states and who exceed the $100 million floor on federal registration. In fact, investment advisers may want the right, but not the obligation, to be able to register at the federal level even if they do not exceed the proposed $100 million floor in the Senate Bill.

(4) Clarification of Rulemaking Authority

The House Bill would allow the SEC to (1) classify persons and matters within its jurisdiction based upon size, scope, business model, compensation scheme or potential to create or increase systemic risk; (2) prescribe different requirements for different classes of persons or matters; and (3) ascribe different meaning to terms, including the term ''client,'' except that the SEC cannot ascribe a meaning thereto that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.[26] Earlier drafts of the House Bill would have given broader flexibility in defining the term ''client'' and could have reversed *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). The draft of the House Bill that passed the House, however, would not allow the SEC to define the term ''client'' if there is an advisory contract. Whether a partnership agreement would constitute an advisory agreement is an open question.

The Senate Bill would clarify that the Commission could promulgate rules and regulations defining technical, trade and other terms under the Advisers Act, except that the Commission shall not define the term ''client'' for the purposes of Section 206(1) and Section 206(2) to include an investor in a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser.[27] The Senate Bill would therefore essentially reaffirm the *Goldstein* decision, except that the Senate Bill leaves open the possibility that the Commission could define ''client'' in another way for purposes other than Section

[24] Senate Report, Section 410.
[25] House Bill, Section 5003.
[26] House Bill, Section 5008.
[27] Senate Bill, Section 406.

206(1) and Section 206(2). The Senate Bill would therefore affirm *Goldstein* in Section 206(1) and (2), reject *Goldstein* in the context of Section 203(b)(3) and leave open the possibility that the SEC could reject it in all other contexts. If the Senate Bill were enacted, investment advisers would therefore need to consider its compliance with regard to investors in funds in more contexts. The Senate Report notes that the Senate Bill's clarification would avoid potential conflicts between fiduciary duties owed by an investment adviser to the fund versus those owed to a particular investor.

(5) Records and Reports of Private Funds

(A) Extension of Record Keeping and Reporting Requirements to Private Funds

The Senate Bill would impose new records and reporting requirements on registered investment advisers by adding a new Section 204(b) to the Advisers Act.[28] Proposed Section 204(b)(1) would authorize the SEC to require any registered investment adviser to maintain such records of and file with the SEC such reports regarding "private funds" advised by the investment adviser as are necessary or appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council (the "Council"), and to provide to the Council those reports, records and the information contained therein. The House Bill's proposal is substantially similar in this regard, except that under the House Bill, the Commission would determine whether systemic risk would need to be assessed in consultation with the Board of Governors of the Federal Reserve System, whereas under the Senate Bill, the Council would assess systemic risk.[29]

(B) Types of Information Subject to Record Keeping and Reporting Requirements

Under the House Bill, the records and reports filed with the SEC under proposed Section 204(b)(2) would include but not be limited to the following information for each "private fund" advised by the registered investment adviser: (A) amount of assets under management; (B) the use of leverage (including off-balance sheet leverage); (C) counterparty credit risk exposures; (D) trading and investment positions; (E) trading practices; and (F) such other information as the SEC, in consultation with the Federal Reserve System, determines necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.[30] The SEC would have the power to set different reporting requirements for different classes of private fund advisers based on the particular types or sizes of private funds advised by such advisers.[31]

Like the House Bill, the Senate Bill would prescribe certain categories of records and reports that must be maintained by private funds advised by an investment adviser and that would be subject to inspection by the Commission. Most of these requirements relate to the status of a fund's portfolio investments as well as to areas that are likely to involve conflicts of interests. Specifically, the Senate Bill would require a description of (A) the amount of assets under management and use of leverage; (B) counterparty credit risk exposure; (C) trading and investment positions; (D) valuation policies and practices of the fund; (E) types of assets held; (F) side arrangements or side letters; (G) trading practices; and (H) other information as the Commission determines is appropriate in the public interest and for the protection of investors or for the assessment of systemic risk, which may include, like under the House Bill, the establishment of different reporting requirements for different classes of fund advisers, based on the type or size of private fund being advised.[32]

The Senate Bill would require a broader array of conflicts of interest disclosure than the House Bill as the Senate Bill would require record keeping and reporting on valuation matters and side letters.

(C) Time Period

Currently, Rule 204-2 requires that records be kept during two years from the end of the fiscal year in which the last entry was made in the appropriate office of the investment adviser, and for another three years preserved in an easily accessible place. As under the House Bill,[33] the Senate Bill would require that a registered investment adviser be required under proposed Section 204(b)(3) to maintain and keep such records of "private funds" advised by the investment adviser for such period as the SEC, by rules and regulations, may prescribe as necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.[34]

(D) To Whom Disclosure Would be Made?

Under the House Bill, in addition to making disclosures to the SEC, registered investment advisers would be required under proposed Section 204(b)(6) 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 may prescribe as necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.[35] Unlike the House Bill, the Senate Bill would not require reporting to investors, counterparties and creditors, but only to the SEC.[36] Note that under securities laws and other provisions of the Advisers Act such as Section 206, investment advisers would continue to be obligated to make disclosures to investors and prospective investors even if the Senate Bill version of the provision were passed.

(E) SEC's Powers to Compel Records

Currently, under Section 204(a), all records of investment advisers are subject at any time to reasonable periodic, special, or other examinations by representatives of the Commission as the Commission deems necessary or appropriate in the public interest. The House Bill would not change this requirement. However, under the House Bill, registered investment advisers must make available to the SEC any copies or extracts from such records as the SEC may reasonably request.[37] Thus, the House Bill would make more explicit the Commission's powers to compel records at any time. As under the House Bill, registered investment advisers under the Senate Bill would be required to make available to the SEC any copies or extracts from such

[28] Senate Bill, Section 404.
[29] House Bill, Section 5004.
[30] House Bill, Section 5004.
[31] House Bill, Section 5004.
[32] Senate Bill, Section 404.
[33] House Bill, Section 5004.
[34] Senate Bill, Section 404.
[35] House Bill, Section 5004.
[36] Senate Bill, Section 404.
[37] House Bill, Section 5004.

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records as the SEC may reasonably request.[38] Thus, the House Bill and the Senate Bill would make more explicit the Commission's powers to compel records at any time.

(F) Information Sharing

Under the Senate Bill, the SEC must make available to the Council copies of all reports, documents, records and information filed with or provided to the SEC by an investment adviser as the Council may consider necessary for the purpose of assessing the systemic risk posed by a private fund.[39] The Council would have the same confidentiality obligations as the SEC under subparagraph (8). The House Bill's information sharing provision is similar, except that the SEC would make information available to the Board of Governors of the Federal Reserve System and to the Council.[40]

(G) Confidentiality of Records and Reports

The House Bill would provide that disclosures by the investment adviser to certain investment advisers would not waive any privileges otherwise applicable to any data or information.[41] The House Bill would provide that ''proprietary information'' of an investment adviser ascertained by the Commission from any filed report with the SEC would be subject to Section 210(b) of the Advisers Act, which places a stronger confidentiality obligation on the Commission.[42] The House Bill would also provide that the SEC could not compel a private fund to disclose ''proprietary information'' to counterparties and creditors.[43] Under the House Bill, ''proprietary information'' would include sensitive nonpublic information regarding the investment adviser's investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property, and any additional information that the SEC determines to be proprietary.[44] Other than with respect to proprietary information, the SEC would be under no obligation to disclose, but could disclose such information.[45]

The Senate Bill would provide that ''the Commission may not be compelled to disclose any report or information contained therein required to be filed with the Commission,'' subject to the Commission's obligations to make disclosure to certain branches of the government.[46] Governmental entities that receive the reports would be subject to the same confidentiality obligation as the SEC under subparagraph (8). Under the Senate Bill, ''proprietary information'' of an investment adviser ascertained by the Commission from any filed report would be subject to Section 210(b) of the Advisers Act, which places a stronger confidentiality obligation on the Commission.[47] It is not clear whether this heightened obligation applies with respect to information sharing and disclosure to other branches of the government by the SEC, since the information sharing and disclosures to governmental entities only reference subparagraph (8) and not subparagraph (10), which is the subparagraph that sets forth the proprietary information exemption.

(H) Future Rulemaking Regarding Reports

Under the House Bill, the SEC and CFTC would be required, under proposed Section 211(e),[48] after consultation with the Council, within 12 months after the date of enactment of the House Bill, to jointly promulgate rules to establish the form and content of reports required to be filed with the SEC under Section 203(l), 203(m) and Section 204(b) and with the CFTC by investment advisers that are registered under both the Advisers Act and the Commodity Exchange Act (''CEA''). The Senate Bill would contain a substantially similar provision.[49]

(I) Examinations

The House Bill would require the Commission under proposed Section 204(b)(5)(A) to conduct periodic inspections of all records of private funds maintained by a registered investment adviser (''RIA'') as the Commission may prescribe.[50] The Senate Bill would require the Commission to conduct periodic inspections of all records of private funds maintained by a registered investment adviser (''RIA'') and to conduct additional examinations as the Commission determines are consistent with the public interest and for the protection of investors, or for the assessment of systemic risk.[51] Currently, RIAs are subject to examinations, but there is no definitive guidance for how often the SEC must conduct its examinations.

(6) Section 210(c)

The House Bill would delete Section 210(c) of the Advisers Act. Section 210(c) currently provides that the SEC cannot require investment advisers to disclose the identity, investments or affairs of any client, except in connection with proceedings or investigations. This requirement could have an adverse effect upon clients whose investment information was sensitive. The Senate Bill would not delete Section 210(c), but would provide that disclosure of such information could be made for purposes of assessment of potential systemic risk,[52] reflecting the Senate Bill's policy focus on systemic risk.

(7) Custody of Client Assets

Currently, the Commission regulates an RIA's custody of client funds and securities through Section 206(4)-2 of the Advisers Act. Section 206(4)-2 also provides certain requirements for safeguarding client funds and securities. The Senate Bill would provide that RIAs must take steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe.[53] Note that the recent Commission amendments to Rule 206(4)-2 require an examination by an independent public accountant, unless an exemption applies. However, the Commission amendments to Rule 206(4)-2 allow RIAs to avoid the examination requirement if certain exemptions are satisfied. The effect of the Senate Bill would therefore be to require examinations by independent public accountants under all cir-

[38] Senate Bill, Section 404.
[39] Senate Bill, Section 404.
[40] House Bill, Section 5004.
[41] House Bill, Section 5004.
[42] Senate Bill, Section 404.
[43] House Bill, Section 5004.
[44] House Bill, Section 5004.
[45] House Bill, Section 5004.
[46] Senate Bill, Section 404.
[47] Senate Bill, Section 404.
[48] House Bill, Section 5008.
[49] Senate Bill, Section 406.
[50] House Bill, Section 5004.
[51] Senate Bill, Section 404.
[52] Senate Bill, Section 405.
[53] Senate Bill, Section 411.

cumstances. It is also possible that the Commission could by rule expand on the RIA's custody obligations and safekeeping requirements in other respects.

(8) Adjustments for Inflation

The House Bill would adjust the ''qualified client'' standard for inflation. The SEC would be required not later than 1 year after the date of the enactment of the House Bill and every 5 years thereafter to adjust for the effects of inflation on such test.[54]

The two major Investment Company Act exemptions, Section 3(c)(1) and Section 3(c)(7), currently rely on a fund's ability to use the private placement exemptions under Section 4(2) and the rules promulgated thereunder. Typically, these securities are placed under Rule 506 promulgated under Regulation D thereunder. Regulation D generally requires that investors be ''accredited investors.''

The Senate Bill originally proposed to raise the income and asset test thresholds for individual accredited investors to correct for inflation since the figures in Regulation D were determined, and to require that the SEC adjust such thresholds not less frequently than once every 4 years.[55] As passed by the Senate, the Senate Bill has proposed that the individual net worth test with respect to ''accredited investors,'' which is currently individual net worth, or joint net worth with a person's spouse, exceeding $1 million (as such amount is adjusted periodically by the SEC), would exclude the value of the primary residence.[56] The Senate Bill would also give the SEC authority to determine whether other requirements of the term ''accredited investor'' should be adjusted for the protection of investors, in the public interest and in light of the economy. Moreover, the SEC would have the obligation to conduct subsequent reviews of the term ''accredited investors'' every 4 years.

We note that such changes will likely impact smaller Section 3(c)(1) exempt funds, which market to ''accredited investors,'' more heavily than Section 3(c)(7) exempt funds, which market to ''qualified purchasers.''

(9) GAO Studies

The House Bill would require the Comptroller General of the United States to carry out a study to assess the annual costs on industry members and their investors due to the registration requirements and the ongoing reporting requirements.[57]

The Senate Bill would require that the Comptroller General of the United States conduct a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds.[58] The Senate Report recognizes that net worth established by a residence, for example, may not render an investor able to fend for himself. The Senate Bill would also require it to conduct a study of the feasibility for forming a self-regulatory organization to oversee private funds.[59] As a result, it is possible that further fund regulation could be on the horizon even after the passage of the Senate Bill, assuming that it becomes enacted. The House Bill does not contain a similar provision.

(10) Commission Study and Report on Short Selling

A number of regulatory measures have recently been taken to regulate short sales, including amendments by the Commission to Regulation SHO. The Senate Bill would direct the Division of Risk, Strategy and Financial Innovation of the Commission to conduct a study on the state of short selling on national securities exchanges and in the over-the-counter markets, with particular attention to the impact of recent rules changes and the incidence of (1) the failure to deliver shares sold short; or (2) delivery of shares on the fourth day following the short sale transaction.[60] Thus, it can be expected that there could be more regulations on short sales. The House Bill does not contain a similar provision.

(11) Transition Period

If enacted, either the House Bill or the Senate Bill would generally become effective 1 year after the date of enactment, except that investment advisers could register with the Commission during that one year period.[61]

(12) Title VI – Improvements to Regulation of Bank and Savings Association Holding Companies and Depositary Institutions

(A) Proprietary Trading Restrictions

The Senate Bill would provide that Federal banking agencies shall prohibit proprietary trading by an insured depository institution, a company that controls, directly or indirectly, an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 and any subsidiary of such institution or company.[62]

''Proprietary trading'' would generally mean ''purchasing or selling, or otherwise acquiring and disposition of stocks, bonds, options, commodities, derivatives or other financial instruments by an insured depository institution, a company that controls, directly or indirectly, an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 and any subsidiary of such institution or company, for the trading book of such institution, company or subsidiary.''[63]

However, subject to restrictions as the Federal banking agencies may determine, ''proprietary trading'' would generally not include activities with respect to the foregoing undertaken on behalf of a customer as part of market making activities or otherwise in connection with or in facilitation of customer relationships, including hedging activities related to such a purchase, sale, acquisition or disposal.[64] The Senate Bill would generally also carve out from these restrictions certain types of governmental securities, although the appropriate Federal banking agencies could impose conditions on the conduct of these investments.[65]

Foreign banks with respect to an investment or activity conducted by such company pursuant to paragraph (9) or (13) of section 4(c) of the Bank Holding Company Act of 1956 solely outside the United States would not be subject to such restrictions, provided that the company is not directly or indirectly controlled by a com-

[54] House Bill, Section 5011.
[55] Senate Bill, Section 412.
[56] Senate Bill, Section 412.
[57] House Bill, Section 5009.
[58] Senate Bill, Section 413.
[59] Senate Bill, Section 414.
[60] Senate Bill, Section 415.
[61] Senate Bill, Section 416; House Bill, Section 5010.
[62] Senate Bill, Section 619.
[63] Senate Bill, Section 619(a)(2)(A).
[64] Senate Bill, Section 619(a)(2)(B).
[65] Senate Bill, Section 619(b)(2)(A); (B).

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pany that is organized under the laws of the United States or a State.[66] Thus, U.S. banks could not set up offshore affiliates to engage in proprietary trading.

(B) Sponsoring and Investing in Private Funds

The Senate Bill would require Federal banking agencies to prohibit an insured depository institution, a company that controls, directly or indirectly, an insured depository institution or is or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 and any subsidiary of such institution or company, from sponsoring or investing in a hedge fund or a private equity fund.[67]

''Sponsoring'' would mean ''(A) serving as a general partner, managing member or trustee of the fund; (B) in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees or management of the fund; or (C) sharing with the fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name.''[68]

Foreign banks with respect to an investment or activity conducted by such company pursuant to paragraph (9) or (13) of section 4(c) of the Bank Holding Company Act of 1956 solely outside the United States would not be subject to such restrictions, provided that the company is not directly or indirectly controlled by a company that is organized under the laws of the United States or a State.[69] Thus, U.S. banks could not set up offshore affiliates to engage in hedge fund and private equity investments and sponsorships.

The Senate Bill would carve out from these restrictions an investment otherwise authorized under Federal law that is (A) an investment in a small business investment company, as that term is defined in section 103 of the Small Business Investment Act of 1958; or (B) designed primarily to promote the public welfare, as provided in the 11th paragraph of section 5136 of the Revised Statues. Note that, as discussed above, small business investment companies could facilitate obtaining investment adviser exemptions under the Advisers Act if the Senate Bill were passed. Thus, it is possible that if the Senate Bill were passed, small business investment companies would assume an added importance.

(C) Restrictions on Investment Advisory Activities

The Senate Bill does not prohibit a bank from acting as an investment manager or investment adviser to hedge funds or private equity funds, but would provide that an insured depository institution, a company that controls an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 and any subsidiary of such institution or company, that serves, directly or indirectly, as the investment manager or investment adviser to a hedge fund or private equity fund may not enter into a covered transaction, as defined in section 23A of the Federal Reserve Act with such hedge fund or private equity fund.[70] ''Covered transaction'' generally is defined certain types of purchase, sale, lending and guaranty transactions between the bank and an affiliate.

In addition, under the Senate Bill, an insured depository institution, a company that controls an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 and any subsidiary of such institution or company, that serves, directly or indirectly, as the investment manager or investment adviser to a hedge fund or private equity fund shall be subject to section 23B of the Federal Reserve Act as if such institution, company or subsidiary were a member bank and hedge fund or private equity fund were an affiliate.[71] Section 23B restricts a range of transactions between banks and affiliates.

(D) Restrictions on Nonbank Companies Supervised by the Board of Governors

The Senate Bill would also potentially subject nonbank companies that are supervised by the Board of Governors and that engage in proprietary trading or sponsoring and investing in hedge funds and private equity funds to additional capital requirements and quantitative limits, to be adopted in the future by the Board of Governors.[72] Such restrictions would not apply with respect to the trading of an investment that is otherwise authorized by Federal law in certain governmental obligations, in small business investment company investments and investments designed primarily to promote the public welfare, as provided in the 11th paragraph of section 5136 of the Revised Statutes.[73]

(E) Council Study and Rulemaking

The Senate Bill would provide direction to the Council to study not later than 6 months after the date of enactment of the Senate Bill to assess the Senate Bill under a range of policy considerations.[74] At the completion of such study, or not later than 9 months after the date of such completion, the appropriate Federal banking agencies and the Board of Governors would be directed to issue final regulations, which would reflect such recommendations made by the Council. Thus, it is possible that more regulation of bank investment activities is on the horizon.

The Senate Report notes that the above banking activities can create conflicts of interest between banking institutions and their customers. Thus, presumably, the Council will assess with more particularity banking practices that are likely to give rise to significant conflicts of interest.

(F) Transition

The final regulations in respect of the foregoing would be effective 2 years after the date on which such final regulations are issued.[75] The transition period could be extended by the appropriate Federal banking agency upon the application of a company if the Federal banking agency determines that an extension would not be detrimental to the public interest.[76] The extension could not exceed (i) 1 year for each determination made by the appropriate Federal banking agency; and (ii) a total of 3 years with respect to any one company.[77]

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[66] Senate Bill, Section 619(b)(3).
[67] Senate Bill, Section 619(c)(1).
[68] Senate Bill, Section 619(a)(3).
[69] Senate Bill, Section 619(c)(2).
[70] Senate Bill, Section 619(e)(1).
[71] Senate Bill, Section 619(e)(2).
[72] Senate Bill, Section 619(f)(1).
[73] Senate Bill, Section 619(f)(2).
[74] Senate Bill, Section 619(g).
[75] Senate Bill, Section 619(h).
[76] Senate Bill, Section 619(h)(2).
[77] Senate Bill, Section 619(h)(2).

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