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The Private Fund Adviser Registration Act

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On October 1, Representative Paul Kanjorski (D-PA) introduced in Congress legislation that substantially mirrors the Obama administration's proposal for the regulation of investment advisers to hedge funds and certain other private investment funds (the "*Registration Bill*").[1] The Registration Bill is the most recent of a series of legislative proposals that would mandate registration of hedge fund managers.[2] Its stated purpose is to amend the U.S. Investment Advisers Act of 1940 (the "*Advisers Act*") "to require advisers of certain unregistered investment companies to register with and provide information to the Securities and Exchange Commission, and for other purposes."

This paper asserts that there are (at least) two flaws with the Registration Bill that should be addressed before any version of the Bill becomes law. In particular, the Registration Bill embodies an inadequate understanding of the use of the term "client" in the Advisers Act and the rules that the SEC has adopted under that Act. In addition, its definition of "private fund" reflects a misunderstanding of the exemptions from registration under the U.S. Investment Company Act of 1940 (the "*Investment Company Act*") on which private funds rely. This paper will discuss each of these items in turn, suggesting that the Registration Bill would do more to further sound and coherent policy if it reflected a better understanding of aspects of the Advisers Act and the Investment Company Act.

I. The Definition of "Client"

One problematic aspect of the Registration Bill is its passing on the opportunity to define "client," thereby likely perpetuating a definition in which each private fund an adviser manages (rather than the investors in those funds) is deemed the adviser's client. That definition not only makes little sense given that the investors are the ones making the decision to put their capital with a fund's adviser but also frustrates efficient resource allocation and the regulatory efficacy of numerous substantive provisions of the Advisers Act. Moreover—and particularly significant in the current environment, in which policymakers and regulators are pursuing encompassing financial regulatory reform—it also arguably undermines a primary policy objective of securities regulation: investor protection.

More specifically, rather than tackling the meaning of "client" itself, the Registration Bill would delegate that authority to the SEC, granting it discretion to "ascribe different meanings to terms ... used in different sections" of the Advisers Act, including the term "client." The inclusion of that authority presumably arises from the D.C. Circuit Court of Appeals' rejection of the SEC's attempt in 2004 to change the meaning of "client" for purposes of the so-called "private adviser exemption" set forth in Section 203(b)(3) of the Advisers Act.[3]

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[1] *See* Anita K. Krug, *Financial Regulatory Reform and Private Funds*, Berkeley Center for Law, Business & the Economy White Paper (July 13, 2009), at 2, available at http://www.law.berkeley.edu/files/FinancialRegulatoryReform_Krug.07.09(1).pdf.

[2] *See, e.g.*, Private Fund Transparency Act of 2009, S. 1276, 111th Cong. (2009) (proposed by Sen. Jack Reed (D-RI) in June); Hedge Fund Adviser Registration Act of 2009, H.R. 711, 111th Cong. (2009) (proposed by Representatives Michael Castle (R-DE) and Michael Capuano (D-MA) in January); Private Fund Investment Advisers Registration Act of 2009, 111th Cong. (2009) (proposed by the Obama administration in July).

[3] That exemption, which generally allows advisers with fewer than 15 "clients" who do not hold themselves out to the public as investment advisers to avoid registering with the SEC under the Advisers

As background, in an effort to require more hedge fund advisers to become registered with the SEC under the Advisers Act, the SEC adopted a rule under the Advisers Act pursuant to which, for purposes of the 15-client limitation of the private adviser exemption, a hedge fund adviser would need to count as clients each *investor* in each fund that it managed, rather than each fund it managed. For other purposes of the Advisers Act, however, the definition of client was not to change—meaning that a hedge fund adviser would continue to regard each fund it managed as their client in connection with complying with the Advisers Act's substantive requirements. The D.C. Circuit vacated the rule on the basis that the SEC had exceeded its authority in changing the definition of "client."[4]

Although it may be appropriate to grant the SEC the authority to define many terms under the Advisers Act, Congress should itself confront the term "client" in order to address anomalies that have arisen from the current definition—and that apparently have received little consideration or discussion in the past year or, indeed, in the past decade. After all, if, as many assume, a version of the Registration Bill will be enacted, the SEC may not deem addressing the definition of client a particularly urgent endeavor. Given that the Registration Bill would eliminate the private adviser exemption for most U.S. hedge fund advisers, Congress's giving the SEC authority to define "client" and other terms in the Advisers Act would no longer have any implications for the concerns driving the SEC's 2004 attempt to mandate registration.[5]

What, then, is problematic about the current interpretation of "client"? The laws and regulations governing investment advisers exist to protect the beneficiaries of the investment advice that an investment adviser provides. Those beneficiaries are the individuals and entities that engage the adviser to provide services for their benefit—*i.e.*, the management of their assets (or assets under their control). Most obvious, then, it is somewhat illogical that, in the context of hedge funds and other private funds, those beneficiaries are not the persons to whom the adviser owes its obligations, which are fiduciary in nature. (Arguably, the focus of the Registration Bill and regulatory reform discussions on requiring private fund advisers to become registered with the SEC may be obscuring the fact that advisers in fact do not owe their obligations to the persons (fund investors) who made the decision to place their assets with the adviser.)

Beyond being counterintuitive, that circumstance produces adverse effects. Among others, it results in anomalies in the application of myriad provisions of the Advisers Act. It arguably also may increase agency costs and, in turn, market inefficiencies.

As an initial matter, the current definition of "client" produces the result that an adviser—which, again, is subject to obligations under the Advisers Act to disclose various types of information to

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Act, has permitted many large private fund managers to remain unregistered on the basis that, in the private fund context, each fund an adviser managers—rather than each investor in those funds—is regarded as the adviser's "client." That interpretation of "client" has meant that advisers may manage up to 14 private funds and remain unregistered, so long as they do not hold themselves out as advisers.

4 After the SEC determined not to seek *certiorari* from the Supreme Court, many hedge fund advisers that became registered in the wake of the rule's adoption withdrew that registration, returning matters to the status quo *ante.*

5 That authority would, however, circumvent similar rulemaking obstacles in the future, a result that the Obama administration and Representative Kanjorski may have deemed worth ensuring in the regulatory reform initiatives.

its clients—is obligated to disclose that information to the funds it manages, rather than to the investors in the funds. However, when the adviser is the party that formed and controls those funds (as their general partner, for example), as is often the case when the adviser is marketing the funds based on its abilities and expertise, the Adviser's disclosure obligations effectively are obligations to disclose information *to itself*.

Another example concerns penalties for a client's termination of advisory services. In situations in which an adviser manages someone's assets not through a fund but through a "separately managed account" arrangement, the SEC deems it a violation of antifraud principles for the adviser to restrict the client's ability to terminate his or her advisory contract, or to subject the client to termination penalties. By contrast, investors in private funds are commonly subject to "lock-up" provisions that prevent them from redeeming their interests in the funds for considerable periods of time. Fund investors may be subject to "early redemption penalties" when they withdraw, or they may be subject to fees for services they did not receive in connection with redemptions. That happens when a fund pays management fees for each period in advance, and an investor withdraws in the middle of the period. Except as may be provided by contract, the adviser is under no obligation to refund prepaid fees.

A third example concerns procedures that an adviser has to follow in engaging a third party—called a solicitor or marketer—to find new potential clients and introduce them to the adviser. The relevant rule under the Advisers Act—the cash solicitation rule—sets out myriad requirements that an adviser needs to comply with. Among them, the adviser needs to require the solicitor to provide solicited persons with information about the compensation the adviser is paying the solicitor; the nature of the relationship between the solicitor and the adviser; and whether any additional fees are being paid by the solicited person as a result of the solicitation arrangement. Those requirements do not apply in connection with the adviser's engagement of a solicitor to solicit *investors* for the funds managed by the adviser.

In each of these examples (and there are others), the differences between the treatment of clients versus the treatment of investors is an elevation of form over substance.

Beyond those effects, however, the current definition of client arguably creates agency costs and may well impede efficient resource allocation. Under agency cost theory, fiduciary duties are a mechanism for reducing oversight costs, particularly where an agent has broad discretion and there exists an asymmetry of information between principal and agent. However, the circumstance that advisers are fiduciaries to their clients loses normative power when the "thing" to which duties are owed is a fund that is under management's (the adviser's) control. That is because it is the investor who puts his or her capital at risk in the fund and makes the decisions regarding his or her investment, and it is the investor who has an interest evaluating whether to leave his or her capital in the fund or to withdraw it and deploy it elsewhere.

It is the investor, therefore, who has the primary interest in reducing agency costs—and agency cost reduction could be better achieved if investors were the beneficiaries of the adviser's fiduciary obligations.[6]

These are problems that the Registration Bill, as it currently stands, will not correct. Beyond

[6] In addition, there is nothing in regulatory or legislative history or judicial precedent to warrant keeping the current definition of "client." If anything, the legislative history of the Advisers Act supports the notion that private fund investors should be seen as advisory clients for purposes of the Advisers Act.

that, however, by perpetuating the current definition of "client" (with no assurances that the SEC will exercise its authority to change that definition), the Registration Bill arguably undermines the policy objectives behind financial regulatory reform efforts.

To be sure, as the Obama administration articulated in proposing the legislation reflected in the Registration Bill, a primary objective behind that legislation is mitigation of systemic risk, a goal for which changing the meaning of "client" may not be relevant. However, at least since the regulatory reforms made in the wake of the Great Depression, the primary goal of securities regulation generally (including as it relates to regulating financial institutions) has been the protection of investors—the persons who place their savings and other available assets in the securities and capital markets.[7] In addition, despite the apparent focus of many current regulatory reform initiatives on reducing systemic risk, current policy discussions reflect a continued recognition of investor protection as an objective guiding the formulation of securities regulation and policy, particularly in light of recent and substantial investor losses that resulted from myriad events and circumstances.

Because a new definition of "client"—one under which a fund's investors are to be regarded as the clients of the fund's adviser—would extend substantive investor protections to those who actually make the decision to place capital with the fund's adviser, Congress's declining to address the issue serves to undermine a dominant goal of securities regulation and reform. Accordingly, Congress should replace the doctrine under which hedge funds and other private funds (rather than investors in those funds) are regarded as the "clients" of the funds' advisers with this new definition, at least to the extent that the adviser sponsored and/or controls the fund, and investors bought interests in the fund on the basis of the adviser's particular skills, expertise, or investment strategies.

II. Definition of "Private Fund"

The Registration Bill's definition of "private fund" is flawed in that, although it is based on a provision of the Investment Company Act that, by its terms, applies only to U.S. funds, it nonetheless purports to encompass non-U.S. funds that are privately offered in the United States. Although the effects of that doctrinal incoherence are not necessarily readily discernible, at the least it will likely render the Bill's application confusing.

The Registration Bill's operative provision, for purposes of investment adviser registration requirements, is to deny advisers to private funds the ability to avail themselves of the private adviser exemption.[8] The Registration Bill would amend the private adviser exemption to specify that the private adviser exemption is available only to "foreign private fund advisers"—which are defined as investment advisers that (i) have no place of business in the United States; (ii) had, during the preceding 12 months, fewer than 15 clients in the United States and less than $25,000,000 under management (or such higher amount as the SEC may specify); (iii) do not hold themselves out to the public in the United States as investment advisers; and (iv) do not act as investment advisers to any investment companies registered as such under the Investment Company Act (such as mutual funds) or certain business development companies. Accordingly, U.S. investment advisers that currently rely on the private adviser exemption would

[7] Certainly that was a goal the SEC articulated in seeking to require hedge fund advisers to register with the SEC in 2004.

[8] *See supra* note 3.

need to become registered as investment advisers with the SEC and comply with the substantive requirements of the Advisers Act[9] (which the Registration Bill would amend to, among other things, require that private fund advisers maintain certain types of books and records as to the private funds they manage and report certain types of information about those funds periodically to the SEC).[10]

The Registration Bill's definition of "private fund," however, reflects a misunderstanding of current law. As the Registration Bill defines it, a private fund is an investment fund that "would be an investment company under section 3(a) of the Investment Company Act of 1940 but for the exception provided from that definition by either sections 3(c)(1) or section 3(c)(7)" of the Investment Company Act *and* that either is organized or otherwise created under the laws of the United States ***or*** that has at least 10% of its outstanding securities owned by U.S. persons. Accordingly, by extending the definition to funds that were not necessarily created under "the laws of the United States," the definition encompasses some funds formed in other countries.[11]

This definition of "private fund" should be familiar to U.S. hedge fund and private equity fund advisers because the funds those advisers sponsor and manage typically avoid having to become registered with the SEC under the Investment Company Act by virtue of meeting the requirements of Section 3(c)(1), which limits the number of investors the fund may have and requires that the fund offer its interests privately, or Section 3(c)(7), which requires that each investor in the fund meet certain relatively high financial sophistication standards and likewise requires that the fund offer its interests privately.

Insofar as U.S. funds are concerned, the definition works. What the Registration Bill fails to reflect, however, is that funds organized outside the United States, by virtue of the Investment Company Act's framework, by definition cannot rely on the Section 3(c)(1) and Section 3(c)(7)

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9 Specifically, advisers that are registered as such under the Advisers Act currently are obligated to, among other things, provide various types of disclosure to their clients and, in certain circumstances, obtain the consent of clients (such as to assign the advisory contract with the client or to engage in certain types of transactions with the client's assets). Registered advisers also need to adopt and adhere to an array of policies and procedures that are intended to address the particular risks and conflicts that inhere in the advisers' particular businesses, and each adviser must designate a "chief compliance officer" to oversee the adviser's compliance program. In addition, each registered adviser, every few years, will be visited by SEC staff, who will examine the adviser's books and records to evaluate whether the adviser is complying with its obligations under the Advisers Act.

10 The Registration Bill would additionally amend two other exemptions to remove any possibility the advisers to private funds could rely on them. In particular, it would eliminate any prospect that private fund advisers could remain unregistered under an exemption currently applicable to any adviser registered with the CFTC as a commodity trading advisor or another exemption available to an adviser whose clients are all residents of the state in which the adviser maintains its principal place of business.

11 The rationale for extending the definition to non-U.S. funds is evident. Many private fund advisers based in the United States sponsor and manage funds formed in the Cayman Islands, British Virgin Islands, or another of several "tax haven" jurisdictions. They do that in order to create investment vehicles that are accommodating to the tax needs of investors that are exempt from U.S. taxation (such as pension plans and charitable foundations) and non-U.S. investors, who often prefer investing non-U.S. entities for their own tax planning needs. The Registration Bill seeks to bring non-U.S. funds within its purview presumably because of the substantial amount of assets managed in those non-U.S. jurisdictions.

exclusions. That result is the product of the fact that the term to which the exclusions expressly apply—"investment company" as defined under section 3(a)—encompasses only *U.S.* investment companies. Accordingly, the Section 3(c)(1) and 3(c)(7) exclusions are irrelevant for any type of investment entity that would not be an "investment company" in the first place.

The Investment Company Act addresses non-U.S. investment companies in Section 7(d). That section specifies that non-U.S. investment companies—or "offshore funds," as they are commonly called—may not register with the SEC as investment companies or publicly offer their securities in the United States unless the SEC finds, as to any offshore fund, that the fund can be effectively subjected to the same type of regulatory oversight as that to which U.S. funds are subject. In other words, if an offshore fund were to seek to offer its securities *publicly* in the United States, they effectively would need the SEC's permission to do so.

Because of that regulatory hurdle, offshore funds initially (in the 1980s) sought to offer their securities in the United States privately, on the premise that doing so would alleviate the Section 7(d) prohibitions (which, again, relate only to public offerings) and that no other provisions of the Investment Company Act were relevant to offshore funds. However, the SEC determined that, in order for offshore funds to engage in private offerings in the United States, they must meet the requirements of Section 3(c)(1) or Section 3(c)(7) in connection with offerings to U.S. persons, notwithstanding that, given the Investment Company Act's structure, those provisions, by their terms, are irrelevant to offshore fund offerings. In the SEC's view, Section 7(d) demonstrates Congress's intent to require offshore funds whose conduct affects investors in the United States to be subject to the same type of regulation governing U.S. funds.

An offshore fund, therefore, necessarily is *not* an investment company under Section 3(a) of the Investment Company Act but for the exclusions provided by Sections 3(c)(1) and 3(c)(7). That conclusion, in turn, means that the definition of "private fund" in the Registration Bill is incoherent insofar as it purports to capture certain offshore funds: a fund relying on a Section 3(c) exclusion cannot have been organized anywhere *other than* under the laws of the United States.

Because of this confusion, a substantially better approach would be for the Registration Bill to expressly acknowledge the different regulatory structure governing non-U.S. private funds, including the ways (if any) in which those entities should be regarded differently from U.S. funds for purposes of the Bill's application.