

INVESTMENT ADVISERS MODERNIZATION ACT OF 2016

\_\_\_\_\_  
JULY 21, 2016.—Committed to the Committee of the Whole House on the State of  
the Union and ordered to be printed  
\_\_\_\_\_

Mr. HENSARLING, from the Committee on Financial Services,  
submitted the following

R E P O R T

together with

MINORITY VIEWS

[To accompany H.R. 5424]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 5424) to amend the Investment Advisers Act of 1940 and to direct the Securities and Exchange Commission to amend its rules to modernize certain requirements relating to investment advisers, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike all after the enacting clause and insert the following:

**SECTION 1. SHORT TITLE.**

This Act may be cited as the “Investment Advisers Modernization Act of 2016”.

**SEC. 2. MODERNIZING CERTAIN REQUIREMENTS RELATING TO INVESTMENT ADVISERS.**

(a) INVESTMENT ADVISORY CONTRACTS.—

(1) ASSIGNMENT.—

(A) ASSIGNMENT DEFINED.—Section 202(a)(1) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(1)) is amended by striking “; but” and all that follows and inserting “; but no assignment of an investment advisory contract shall be deemed to result from the death or withdrawal, or the sale or transfer of the interests, of a minority of the members, partners, shareholders, or other equity owners of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members, partners, shareholders, or other equity owners who, after such admission, shall be only a minority of the members, partners, shareholders, or other equity owners and shall have only a minority interest in the business.”.

(B) CONSENT TO ASSIGNMENT BY QUALIFIED CLIENTS.—Section 205(a)(2) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-5(a)(2)) is amended by inserting before the semicolon the following: “, except that if such other party is a qualified client (as defined in section 275.205-3 of title 17, Code of Federal Regulations, or any successor thereto), such other party may provide such consent at the time the parties enter into, extend, or renew such contract”.

(2) NOT REQUIRED TO PROVIDE FOR NOTIFICATION OF CHANGE IN MEMBERSHIP OF PARTNERSHIP.—Section 205 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-5) is amended—

(A) in subsection (a)—

- (i) in paragraph (1), by striking the semicolon and inserting “; or”;
- (ii) in paragraph (2), by striking “; or” and inserting a period; and
- (iii) by striking paragraph (3); and

(B) in subsection (d), by striking “paragraphs (2) and (3) of subsection (a)” and inserting “subsection (a)(2)”.

(b) ADVERTISING RULE.—

(1) IN GENERAL.—Not later than 90 days after the date of the enactment of this Act, the Commission shall amend section 275.206(4)-1 of title 17, Code of Federal Regulations, to provide that paragraphs (a)(1) and (a)(2) of such section do not apply to an advertisement that an investment adviser publishes, circulates, or distributes solely to persons described in paragraph (2) of this subsection.

(2) PERSONS DESCRIBED.—A person is described in this paragraph if such person is, or the investment adviser reasonably believes such person is—

(A) a qualified client (as defined in section 275.205-3 of title 17, Code of Federal Regulations), determined as of the time of the publication, circulation, or distribution of the advertisement rather than immediately prior to or after entering into the investment advisory contract referred to in such section;

(B) a knowledgeable employee (as defined in section 270.3c-5 of title 17, Code of Federal Regulations) of any private fund to which the investment adviser acts as an investment adviser;

(C) a qualified purchaser (as defined in section 2(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a))); or

(D) an accredited investor (as defined in section 230.501 of title 17, Code of Federal Regulations), determined as if the investment adviser were the issuer of securities referred to in such section and the time of the publication, circulation, or distribution of the advertisement were the sale of such securities.

### SEC. 3. REMOVING DUPLICATIVE BURDENS AND APPROPRIATELY TAILORING CERTAIN REQUIREMENTS.

(a) BROCHURE DELIVERY.—Not later than 90 days after the date of the enactment of this Act, the Commission shall amend section 275.204-3(c) of title 17, Code of Federal Regulations, to provide that an investment adviser is not required to deliver a brochure or brochure supplement to a client that is a limited partnership, limited liability company, or other pooled investment vehicle for which each limited partner, member, or other equity owner has received, before purchasing a security issued by the pooled investment vehicle, a prospectus, private placement memorandum, or other offering document containing (to the extent material to an understanding of the pooled investment vehicle, the business of the pooled investment vehicle, and the securities being offered by the pooled investment vehicle) substantially the same information as would be required by Part 2A or 2B of Form ADV at the time of delivery of the brochure or brochure supplement, as the case may be.

(b) FORM PF.—Not later than 90 days after the date of the enactment of this Act, the Commission shall amend section 275.204(b)-1 of title 17, Code of Federal Regulations, to provide that an investment adviser to a private fund is not required to report any information beyond that which is required by sections 1a and 1b of Form PF, unless such investment adviser is a large hedge fund adviser or a large liquidity fund adviser (as such terms are defined in such Form).

(c) CUSTODY RULE.—Not later than 90 days after the date of the enactment of this Act, the Commission shall amend section 275.206(4)-2 of title 17, Code of Federal Regulations, as follows:

(1) The Commission shall provide additional exceptions to the independent verification requirement of paragraph (a)(4) of such section for an investment adviser with respect to funds and securities of a limited partnership (or a limited liability company or other type of pooled investment vehicle), as follows:

(A) An exception that applies if the outstanding securities (other than short-term paper, as defined in section 2(a) of the Investment Company Act

of 1940 (15 U.S.C. 80a-2(a)) of the pooled investment vehicle are beneficially owned exclusively by—

- (i) the investment adviser;
- (ii) affiliated persons of the investment adviser;
- (iii) supervised persons of the investment adviser;
- (iv) officers, directors, and employees of the affiliated persons of the investment adviser;
- (v) family members and former family members (as such terms are defined in section 275.202(a)(11)(G)-1 of title 17, Code of Federal Regulations) of persons described in clause (iii) or (iv); or
- (vi) officers, directors, employees, or affiliated persons of, or persons who provide, have provided, or have entered into a contract to provide services to—
  - (I) the investment adviser of the pooled investment vehicle;
  - (II) one or more clients of the investment adviser of the pooled investment vehicle; or
  - (III) issuers from which the pooled investment vehicle or any other client of the investment adviser of the pooled investment vehicle has acquired securities, such as the portfolio company of a private fund.

(B) An exception that applies if the pooled investment vehicle has been established to hold only the securities of a single issuer in which one or more pooled investment vehicles managed by the investment adviser have acquired a controlling interest.

(2) Consistent with, and expanding on, IM Guidance Update No. 2013-04, titled “Privately Offered Securities under the Investment Advisers Act Custody Rule”, published by the Division of Investment Management of the Commission, the Commission shall, with respect to the exception for certain privately offered securities in paragraph (b)(2) of such section—

- (A) remove the requirement of clause (i)(B) of such paragraph (relating to the uncertificated nature and recordation of ownership of the securities); and
- (B) remove the requirement of clause (ii) of such paragraph (relating to audit and financial statement distribution requirements with respect to securities of pooled investment vehicles).

(d) PROXY VOTING RULE.—Not later than 90 days after the date of the enactment of this Act, the Commission shall amend section 275.206(4)-6 of title 17, Code of Federal Regulations, to provide that such section does not apply to any voting authority with respect to client securities that are not public securities.

**SEC. 4. FACILITATING ROBUST CAPITAL FORMATION BY PREVENTING REGULATORY MISMATCH.**

The Commission may not—

- (1) amend section 230.156 of title 17, Code of Federal Regulations, to extend the provisions of such section to offerings of securities issued by private funds; or
- (2) adopt rules applicable to offerings of securities issued by private funds that are substantially the same as the provisions of such section.

**SEC. 5. EXCLUSION OF ADVISORY SERVICES TO REGISTERED INVESTMENT COMPANIES.**

This Act shall not apply with respect to advisory services provided, or proposed to be provided, to an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.).

**SEC. 6. REFERENCES TO REGULATIONS.**

In this Act, any reference to a regulation shall be construed to refer to such regulation or any successor thereto.

**SEC. 7. DEFINITIONS.**

In this Act:

- (1) PUBLIC SECURITY.—The term “public security” means a security issued by an issuer that—
  - (A) is required to submit reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a); 78o(d)); or
  - (B) has a security that is listed or traded on any exchange or organized market operating in a foreign jurisdiction.
- (2) TERMS DEFINED IN INVESTMENT ADVISERS ACT OF 1940.—The terms defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)) have the meanings given such terms in such section.

## PURPOSE AND SUMMARY

Introduced by Representatives Robert Hurt, Bill Foster, Randy Hultgren, Kyrsten Sinema, Steve Stivers and Juan Vargas, on June 9, 2016, H.R. 5424, the Investment Advisers Modernization Act of 2016, updates the application of the Investment Advisers Act of 1940 (“Advisers Act”) to better reflect today’s capital markets. The Investment Advisers Modernization Act of 2016, as amended, would make modest, common sense modifications to the IAA while maintaining strong regulatory oversight of investment advisers.

## BACKGROUND AND NEED FOR LEGISLATION

The rationale for most federal securities regulation is to protect ordinary investors. Under this rationale, federal securities regulation is supposed to protect those investors who may lack the sophistication to knowledgably invest in complex or esoteric securities, or who may not be wealthy enough to withstand significant losses on their investments. By contrast, investors who have significant personal wealth or expertise are considered to be sufficiently sophisticated that they do not require the same level of protection that the securities laws afford to other investors. These investors often pool their funds in private investment vehicles to expand the reach of their investment portfolios beyond equity securities or mutual funds to include real estate, oil and gas partnerships, or private equity or debt offerings. Private equity funds are an important source of capital in the economy and were not a cause of the 2008 financial crisis. They should not be subject to stifling regulations that only have the effect of limiting private equity’s ability to invest in American businesses.

Mr. Joshua Cherry-Seto, Chief Financial Officer of Blue Wolf Capital Partners, LLC, testified before the Subcommittee on Capital Markets and Government Sponsored Enterprises on May 17, 2016, in support of H.R. 5424 and he observed that as a result of the Advisers Act’s “ambiguity, firms like ours spend many hours and significant dollars trying to comply with ill-fitting rules for our industry that don’t further the intent to protect our investors, including spending investor resources on advisors and lawyers to try to interpret regulations not specifically written with our industry in mind.”

*Private equity*

Private equity firms are also structured as limited partnerships, but unlike hedge funds they usually employ just one main investment strategy: buying and selling other businesses. Most private equity firms provide financing and management to financially troubled existing businesses or to start-up businesses, or they create buyout funds by acquiring ownership positions in businesses of all sizes, usually through a leveraged buyout. Both types of private equity investments seek to make profits for their investors by improving the business operations of the companies they acquire, rearranging their capital structure, or selling the business through an initial public offering or to a larger company.

*Private investment funds and the Dodd-Frank Act*

Title IV of the Dodd-Frank Act imposes new registration and reporting requirements on advisers to hedge funds and private equity funds. Title IV also eliminated an exemption for advisers that serve less than fifteen clients, an exemption that was commonly exercised by private fund advisers. Title IV requires investment advisers to private investment funds to register with the Securities and Exchange Commission (SEC) under the Advisers Act. Private funds are defined as those funds that meet the definition of investment companies under the Advisers Act.

Title IV of the Dodd-Frank Act exempts from registration advisers to VC funds (as defined by the SEC's definition) as well as advisers to Small Business Investment Companies (SBICs). Private fund advisers with assets under management of less than \$150 million qualify for a limited exemption from registration if they comply with recordkeeping and reporting requirements established by the SEC. The Dodd-Frank Act also exempts "family offices" from registration, as those are defined by SEC rule. Lastly, advisers registered with the Commodity Futures Trading Commission as commodity trading advisers are exempt from registration, unless the business of the adviser becomes predominantly securities-related.

Title IV's registration requirements impose a duty on the advisers to private funds to maintain records and file reports with the SEC, which are made available to other regulators, including the Financial Stability Oversight Council. These records must include the amount of assets under management and use of leverage, counterparty credit exposure, trading and investment positions, valuation policies and practices, types of assets held, side arrangements, trading practices, and other information the SEC, in consultation with the Financial Stability Oversight Council, deems necessary to promote the public interest or facilitate the assessment of systemic risk.

Title IV directs the SEC to periodically examine the records of private fund advisers, and it authorizes the SEC to conduct additional examinations as the SEC deems necessary. Private fund investment advisers are required to safeguard client assets over which they have custody, and assets must be verified by independent accountants.

Advisers also must report on Form ADV general information about private funds that they manage, such as basic organizational and operational information, fund size and ownership. Form PF is filed by SEC-registered investment advisers with at least \$150 million in private funds assets under management to report information about the private funds that they manage. Most advisers file Form PF annually to report general information such as the types of private funds advised (e.g., hedge funds or private equity), each fund's size, leverage, liquidity and types of investors. Certain larger advisers provide more information on a more frequent basis (including more detailed information on certain larger funds).

*SEC Regulation of private funds*

The SEC has reported that since the enactment of the Dodd-Frank Act, approximately 1,800 advisers to hedge funds and private equity funds have registered with the SEC. Beginning in 2013, the SEC began to conduct "presence" examinations, which "are

more streamlined than typical examinations, and are designed both to engage with the new registrants to inform them of their obligations as registered entities and to permit the Commission to examine a higher percentage of new registrants.” While the SEC’s stated examination goal is to identify systemic risks at private funds, the examinations have mainly served to identify deficiencies related to investor protection. Unfortunately, once the adviser to a private equity fund became subject to the SEC’s jurisdiction, the SEC has disproportionately focused on these firms, rather than asset managers. Former SEC Commissioner Dan Gallagher testified before the Subcommittee on Capital Markets and Government Sponsored Enterprises on May 17, 2016 that, “such advisers must bear the burden of the ongoing compliance costs that come with SEC registration and reporting on Form PF. This will continue to impose significant costs and burdens not only on the private advisers, but also on the Commission. And yet, this expansion of our regulatory reach will not serve to protect ordinary retail investors, but rather investors who could, as the Supreme Court so notably said, “fend for themselves.”

It is also important to note that the Advisers Act was enacted in 1940 to address the roles and responsibilities of investment advisers, which at the time included investment trusts and investment companies. Many of the Act’s provisions are structured around investment advisers’ involvement with publicly traded securities and retail-facing investors, and this does not fit the business model of the private equity industry.

Given the antiquated application of the statute and the growth of private equity, private fund advisers now registered with the SEC are required to comply with numerous requirements that do not fit their business model. Private fund advisers spend hundreds of thousands, if not millions of dollars on complying with these rules and have dedicated countless hours to compiling information and reports, which provides little to no benefit to regulators or the investment community. Commissioner Gallagher notes that the Act is not the best legal framework for the regulation of private fund advisers and that, “higher costs will threaten the ability of certain funds—such as certain private equity funds—to promote capital formation through investments in operating companies. And let me be clear: capital formation leads to job creation, which is something we could certainly use right now. Indeed, around 4,100 private equity firms headquartered in the U.S. currently back about 14,300 American businesses. These private equity-backed companies have hired around 7.5 million employees as of March 2016.”

Private equity fund advisers have engaged regularly with the SEC in hopes of modifying the reporting requirements so that they are appropriate for such funds and are more helpful to regulators. H.R. 5424, the Investment Advisers Modernization Act of 2016, would make several modifications to the IAA as it relates to private fund registration while largely maintaining the existing regulatory structure for investment advisers. Specifically, the bill would remove or modernize some of the more unnecessary and overly burdensome requirements in the IAA that serve only to drive up the costs for funds and investors, and that hinder the efficient allocation of capital that helps grow businesses and jobs. For example, the bill would permit advisers to advertise previous recommenda-

tions to certain clients, modify rules related to the assignment of advisory contracts, and revise the custody rule for advisers to funds and securities of a limited partnership. Additionally, the bill would reduce Form PF reporting obligations for certain adviser.

#### *Conclusion*

Mr. Cherry-Seto noted that H.R. 5424, “provides a modernized, clear and rational regulatory framework for advisers to comply with, given current realities. This will allow for regulatory oversight that is efficient and meaningful, while allowing private equity advisers to continue to focus on growing companies, providing important returns to our investors, and most importantly, creating new jobs, now and into the future.”

#### HEARING

The Committee on Financial Services’ Subcommittee on Capital Markets and Government Enterprises held a hearing examining matters relating to H.R. 5424 on May 17, 2016.

#### COMMITTEE CONSIDERATION

The Committee on Financial Services met in open session on June 16, 2016, and ordered H.R. 5424 to be reported favorably to the House as amended by a recorded vote of 47 yeas to 12 nays (recorded vote no. FC-109), a quorum being present.

#### COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. The sole record vote in committee was a motion by Chairman Hensarling to report the bill favorably to the House as amended. That motion was agreed to by a recorded vote of 47 yeas to 12 nays (Record vote no. FC-109), a quorum being present.

## Record vote no. FC-109

Representative	Yea	Nay	Present	Representative	Yea	Nay	Present
Mr. Hensarling .....	X			Ms. Waters (CA) .....		X	
Mr. King (NY) .....	X			Mrs. Maiorone (NY) .....		X	
Mr. Royce .....	X			Ms. Velázquez .....		X	
Mr. Lucas .....	X			Mr. Sherman .....	X		
Mr. Garrett .....	X			Mr. Meeks .....	X		
Mr. Neugebauer .....	X			Mr. Capuano .....		X	
Mr. McHenry .....	X			Mr. Hinojosa .....		X	
Mr. Pearce .....	X			Mr. Clay .....		X	
Mr. Posey .....	X			Mr. Lynch .....		X	
Mr. Fitzpatrick .....	X			Mr. David Scott (GA) .....	X		
Mr. Westmoreland .....	X			Mr. Al Green (TX) .....		X	
Mr. Luetkemeyer .....	X			Mr. Cleaver .....		X	
Mr. Huizenga (MI) .....	X			Ms. Moore .....		X	
Mr. Duffy .....	X			Mr. Ellison .....		X	
Mr. Hurt (VA) .....	X			Mr. Perlmutter .....	X		
Mr. Stivers .....	X			Mr. Himes .....	X		
Mr. Fincher .....				Mr. Carney .....	X		
Mr. Stutzman .....	X			Ms. Sewell (AL) .....	X		
Mr. Mulvaney .....	X			Mr. Foster .....	X		
Mr. Hultgren .....	X			Mr. Kildee .....		X	
Mr. Ross .....	X			Mr. Murphy (FL) .....	X		
Mr. Pittenger .....	X			Mr. Delaney .....	X		
Mrs. Wagner .....	X			Ms. Sinema .....	X		
Mr. Barr .....	X			Mrs. Beatty .....	X		
Mr. Rothfus .....	X			Mr. Heck (WA) .....	X		
Mr. Messer .....	X			Mr. Vargas .....	X		
Mr. Schweikert .....	X						
Mr. Guinta .....	X						
Mr. Tipton .....	X						
Mr. Williams .....	X						
Mr. Poliquin .....	X						
Mrs. Love .....	X						
Mr. Hill .....	X						
Mr. Emmer .....	X						

COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the findings and recommendations of the committee based on oversight activities under clause 2(b)(1) of rule X of the Rules of the House of Representatives, are incorporated in the descriptive portions of this report.

PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee states that H.R. 5424 will modernize aspects of the Investment Advisers Act (IAA) by removing duplicative burdens, address practical concerns with the IAA, and help facilitate capital formation. H.R. 5424 will also help the SEC prioritize its limited resources towards the protection of less sophisticated investors who invest through an Investment Adviser.

NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee adopts as its own the estimate of new budget authority, entitlement authority, or tax expenditures or revenues contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

COMMITTEE COST ESTIMATE

The Committee adopts as its own the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

CONGRESSIONAL BUDGET OFFICE ESTIMATES

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

U.S. CONGRESS,  
CONGRESSIONAL BUDGET OFFICE,  
*Washington, DC, July 12, 2016.*

Hon. JEB HENSARLING,  
*Chairman, Committee on Financial Services,  
U.S. House of Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 5424, the Investment Advisers Modernization Act of 2016.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Stephen Rabent.

Sincerely,

KEITH HALL.

Enclosure.

*H.R. 5424—Investment Advisers Modernization Act of 2016*

Under current law, the Securities and Exchange Commission (SEC) enforces rules and requirements for advertising, transferring, and selling funds and securities by investment advisers. H.R. 5424 would provide investment advisers several exemptions from certain of those requirements. It also would prohibit the SEC from applying its rules to private funds that provide sales literature about their securities offerings.

On the basis of information provided by the SEC, CBO estimates that implementing H.R. 5424 would cost \$2 million over the 2017–2021 period for increased administrative activities related to revising current agency rules. However, the SEC is authorized to collect fees sufficient to offset its annual appropriation; therefore, CBO estimates that the net effect on discretionary spending would be negligible, assuming appropriations actions consistent with that authority.

Enacting H.R. 5424 would not affect direct spending or revenues; therefore, pay-as-you-go procedures do not apply. CBO estimates that enacting H.R. 5424 would not increase net direct spending or on-budget deficits in any of the four consecutive 10-year periods beginning in 2027.

H.R. 5424 contains no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would not affect the budgets of state, local, or tribal governments.

If the SEC increases fees to offset any costs of implementing the bill, H.R. 5424 would increase the cost of an existing mandate on private entities required to pay those fees. Based on information from the SEC, CBO estimates that the aggregate cost of the mandate, if imposed, would be minimal and would fall well below the annual threshold for private-sector mandates established in UMRA (\$154 million in 2016, adjusted annually for inflation).

The CBO staff contact for this estimate is Stephen Rabent. The estimate was approved by H. Samuel Papenfuss, Deputy Assistant Director for Budget Analysis.

## FEDERAL MANDATES STATEMENT

The Committee adopts as its own the estimate of Federal mandates prepared by the Director of the Congressional Budget Office pursuant to section 423 of the Unfunded Mandates reform Act.

## ADVISORY COMMITTEE STATEMENT

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

## APPLICABILITY TO LEGISLATIVE BRANCH

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of the section 102(b)(3) of the Congressional Accountability Act.

## EARMARK IDENTIFICATION

H.R. 5424 does not contain any congressional earmarks, limited tax benefits, or limited tariff benefits as defined in clause 9 of rule XXI.

## DUPLICATION OF FEDERAL PROGRAMS

Pursuant to section 3(g) of H. Res. 5, 114th Cong. (2015), the Committee states that no provision of H.R. 5424 establishes or re-authorizes a program of the Federal Government known to be duplicative of another Federal program, a program that was included in any report from the Government Accountability Office to Congress pursuant to section 21 of Public Law 111–139, or a program related to a program identified in the most recent Catalog of Federal Domestic Assistance.

## DISCLOSURE OF DIRECTED RULEMAKING

Pursuant to section 3(i) of H. Res. 5, 114th Cong. (2015), the Committee states that H.R. 5424 directs the SEC to both revise and amend certain rules as directed by the legislation.

## SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

*Section 1: Short title*

This section cites H.R. 5424 as the “Investment Advisers Modernization Act of 2016.”

*Section 2: Modernizing certain requirements relating to investment advisers*

This section makes the following changes:

## 1) Removes Overly-Broad Restrictions on Assignments:

Updates the definition of “assignment” to clarify that an assignment shall not be deemed to result from the death, withdrawal, sale or transfer of minority interests. Allows qualified clients to consent to transfer of interests at the time they enter into an advisory contract.

## 2) Adjusts Outdated and Duplicative Requirements Regarding Any Change in Membership:

Allows advisers organized as partnerships to change the composition of the partnership without providing notice every time there is a change in the partnership.

## 3) Modifies Advertising Rule:

This section would remove the applicability of Rule 206(4)–1(a)(1) & (a)(2) for advisers who advertise exclusively to accredited investors, qualified clients, qualified purchasers, or knowledgeable employees. It is important to note that the basic anti-fraud provisions for private funds remain in place under Rule 206(4)–8, and the other portions of the advertising rule will remain in effect.

*Section 3: Removing duplicative burdens and appropriately tailoring certain requirements*

This section makes the following changes:

## 1) Appropriately Tailors Brochure Requirements on Part 2 of Form ADV:

Exempts private fund sponsors from requirement to complete and deliver Part 2A & 2B, provided that the private placement memorandum contains the information required by the form (to the extent such information is material to the offering by the private fund). Private fund sponsors could still complete and deliver Part 2A & 2B if they so choose.

2) Appropriately Tailors Form PF:

Removes the special section (Part 4) on Form PF for private equity funds and their portfolio companies and places them on the same reporting basis as other private fund sponsors who are not large hedge fund or liquidity fund sponsors. Advisers to private equity firms would still report all of the information required in Part 1 of Form PF, which will provide the Financial Stability Oversight Council the information that it needs to assess the financial system as required by the Dodd-Frank Act.

3) Updates the Custody Rule:

The SEC has already limited application of the Custody Rule for private equity firms through interpretive guidance in two separate instances—acknowledging that the Custody Rule in many respects places unfair costs and burdens on private equity firms. The proposed legislation further develops the guidance already issued by the SEC by expanding the “privately offered securities” exemption so that it applies to both certificated and uncertificated securities and providing an exemption for special purpose vehicles (SPV) managed by private fund sponsors and co-investment funds that hold only one investment.

4) Adjusts Proxy Voting Rule in a Common Sense Way

Provides an exemption from the rule where an investment adviser exercises voting authority only with respect to non-public securities.

*Section 4: Facilitating robust capital formation by preventing regulatory mismatch*

This section would prevent the misapplication of Rule 156 in the private funds space, thereby enabling both regulators and investors alike to understand that private funds and mutual funds are significantly different types of investment vehicles.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, and existing law in which no change is proposed is shown in roman):

**INVESTMENT ADVISERS ACT OF 1940**

**TITLE II—INVESTMENT ADVISERS**

\* \* \* \* \*

DEFINITIONS

SEC. 202. (a) When used in this title, unless the context otherwise requires, the following definitions shall apply:

(1) “Assignment” includes any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor’s outstanding voting securities by a security holder of the assignor; but if the investment adviser is a partnership, no assignment of an investment advisory contract shall be deemed to result from the death or withdrawal of a minority of the members of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members who, after such admission, shall be only a minority of the members and shall have only a minority interest in the business.]; *but no assignment of an investment advisory contract shall be deemed to result from the death or withdrawal, or the sale or transfer of the interests, of a minority of the members, partners, shareholders, or other equity owners of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members, partners, shareholders, or other equity owners who, after such admission, shall be only a minority of the members, partners, shareholders, or other equity owners and shall have only a minority interest in the business.*

(2) “Bank” means (A) a banking institution organized under the laws of the United States or a Federal savings association, as defined in section 2(5) of the Home Owners’ Loan Act, (B) a member bank of the Federal Reserve System, (C) any other banking institution, savings association, as defined in section 2(4) of the Home Owners’ Loan Act, or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

(3) The term “broker” has the same meaning as given in section 3 of the Securities Exchange Act of 1934.

(4) “Commission” means the Securities and Exchange Commission.

(5) “Company” means a corporation, a partnership, an association, a joint-stock company, a trust, or any organized group of persons, whether incorporated or not; or any receiver, trustee in a case under title 11 of the United States Code, or similar official, or any liquidating agent for any of the foregoing, in his capacity as such.

(6) “Convicted” includes a verdict, judgment, or plea of guilty, or a finding of guilt on a plea of nolo contendere, if such verdict, judgment, plea, or finding has not been reversed, set aside, or withdrawn, whether or not sentence has been imposed.

(7) The term “dealer” has the same meaning as given in section 3 of the Securities Exchange Act of 1934, but does not include an insurance company or investment company.

(8) “Director” means any director of a corporation or any person performing similar functions, with respect to any organization, whether incorporated or unincorporated.

(9) “Exchange” means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

(10) “Interstate commerce” means trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof.

(11) “Investment adviser” means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company, except that the term “investment adviser” includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934, as exempted securities for the purposes of that Act; (F) any nationally recognized statistical rating organization, as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934, unless such organization engages in issuing recommendations as to purchasing, selling, or holding securities or in managing assets, consisting in whole or in part of securities, on behalf of others;

(G) any family office, as defined by rule, regulation, or order of the Commission, in accordance with the purposes of this title; or (H) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

(12) “Investment company”, affiliated person, and “insurance company” have the same meanings as in the Investment Company Act of 1940. “Control” means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.

(13) “Investment supervisory services” means the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client.

(14) “Means or instrumentality of interstate commerce” includes any facility of a national securities exchange.

(15) “National securities exchange” means an exchange registered under section 6 of the Securities Exchange Act of 1934.

(16) “Person” means a natural person or a company.

(17) The term “person associated with an investment adviser” means any partner, officer, or director of such investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser, except that for the purposes of section 203 of this title (other than subsection (f) thereof), persons associated with an investment adviser whose functions are clerical or ministerial shall not be included in the meaning of such term. The Commission may by rules and regulations classify, for the purposes of any portion or portions of this title, persons, including employees controlled by an investment adviser.

(18) “Security” means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing.

(19) “State” means any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.

(20) “Underwriter” means any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking,

or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributor's or seller's commission. As used in this paragraph the term "issuer" shall include in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

(21) "Securities Act of 1933", "Securities Exchange Act of 1934", and "Trust Indenture Act of 1939", mean those Acts, respectively, as heretofore or hereafter amended.

(22) "Business development company" means any company which is a business development company as defined in section 2(a)(48) of title I of this Act and which complies with section 55 of title I of this Act, except that—

(A) the 70 per centum of the value of the total assets condition referred to in sections 2(a)(48) and 55 of title I of this Act shall be 60 per centum for purposes of determining compliance therewith;

(B) such company need not be a closed-end company and need not elect to be subject to the provisions of sections 55 through 65 of title I of this Act; and

(C) the securities which may be purchased pursuant to section 55(a) of title I of this Act may be purchased from any person.

For purposes of this paragraph, all terms in sections 2(a)(48) and 55 of title I of this Act shall have the same meaning set forth in such title as if such company were a registered closed-end investment company, except that the value of the assets of a business development company which is not subject to the provisions of sections 55 through 65 of title I of this Act shall be determined as of the date of the most recent financial statements which it furnished to all holders of its securities, and shall be determined no less frequently than annually.

(23) "Foreign securities authority" means any foreign government, or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters.

(24) "Foreign financial regulatory authority" means any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade or foreign equivalent, or other financial activities, or (C) membership organization a function of which is to regulate the participation of its members in activities listed above.

(25) "Supervised person" means any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the invest-

ment adviser and is subject to the supervision and control of the investment adviser.

(26) The term “separately identifiable department or division” of a bank means a unit—

(A) that is under the direct supervision of an officer or officers designated by the board of directors of the bank as responsible for the day-to-day conduct of the bank’s investment adviser activities for one or more investment companies, including the supervision of all bank employees engaged in the performance of such activities; and

(B) for which all of the records relating to its investment adviser activities are separately maintained in or extractable from such unit’s own facilities or the facilities of the bank, and such records are so maintained or otherwise accessible as to permit independent examination and enforcement by the Commission of this Act or the Investment Company Act of 1940 and rules and regulations promulgated under this Act or the Investment Company Act of 1940.

(27) The terms “security future” and “narrow-based security index” have the same meanings as provided in section 3(a)(55) of the Securities Exchange Act of 1934.

(28) The term “credit rating agency” has the same meaning as in section 3 of the Securities Exchange Act of 1934.

(29) The term “private fund” means an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3), but for section 3(c)(1) or 3(c)(7) of that Act.

(30) The term “foreign private adviser” means any investment adviser who—

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

(B) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser;

(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 (15 U.S.C. 80a–53), and has not withdrawn its election.

(29) The terms “commodity pool”, “commodity pool operator”, “commodity trading advisor”, “major swap participant”, “swap”, “swap dealer”, and “swap execution facility” have the same

meanings as in section 1a of the Commodity Exchange Act (7 U.S.C. 1a).

(b) No provision in this title shall apply to, or be deemed to include, the United States, a State, or any political subdivision of a State, or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned directly or indirectly by any one or more of the foregoing, or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty, unless such provision makes specific reference thereto.

(c) CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION.—Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

\* \* \* \* \*

#### INVESTMENT ADVISORY CONTRACTS

SEC. 205. (a) No investment adviser registered or required to be registered with the Commission shall enter into, extend, or renew any investment advisory contract, or in any way perform any investment advisory contract entered into, extended, or renewed on or after the effective date of this title, if such contract—

(1) provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client【;】;  
or

(2) fails to provide, in substance, that no assignment of such contract shall be made by the investment adviser without the consent of the other party by the contract, *except that if such other party is a qualified client (as defined in section 275.205-3 of title 17, Code of Federal Regulations, or any successor thereto), such other party may provide such consent at the time the parties enter into, extend, or renew such contract* 【; or】.

【(3) fails to provide, in substance, that the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of such partnership within a reasonable time after such change.】

(b) Paragraph (1) of subsection (a) shall not—

(1) be construed to prohibit an investment advisory contract which provides for compensation based upon the total value of a fund averaged over a definite period, or as of definite dates, or taken as of a definite date;

(2) apply to an investment advisory contract with—

(A) an investment company registered under title I of this Act, or

(B) any other person (except a trust, governmental plan, collective trust fund, or separate account referred to in section 3(c)(11) of title I of this Act), provided that the contract relates to the investment of assets in excess of \$1 million,

if the contract provides for compensation based on the asset value of the company or fund under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices or such other measure of investment performance as the Commission by rule, regulation, or order may specify;

(3) apply with respect to any investment advisory contract between an investment adviser and a business development company, as defined in this title, if (A) the compensation provided for in such contract does not exceed 20 per centum of the realized capital gains upon the funds of the business development company over a specified period or as of definite dates, computed net of all realized capital losses and unrealized capital depreciation, and the condition of section 61(a)(3)(B)(iii) of title I of this Act is satisfied, and (B) the business development company does not have outstanding any option, warrant, or right issued pursuant to section 61(a)(3)(B) of title I of this Act and does not have a profit-sharing plan described in section 57(n) of title I of this Act;

(4) apply to an investment advisory contract with a company excepted from the definition of an investment company under section 3(c)(7) of title I of this Act; or

(5) apply to an investment advisory contract with a person who is not a resident of the United States.

(c) For purposes of paragraph (2) of subsection (b), the point from which increases and decreases in compensation are measured shall be the fee which is paid or earned when the investment performance of such company or fund is equivalent to that of the index or other measure of performance, and an index of securities prices shall be deemed appropriate unless the Commission by order shall determine otherwise.

(d) As used in [paragraphs (2) and (3) of subsection (a)] *subsection (a)(2)*, “investment advisory contract” means any contract or agreement whereby a person agrees to act as investment adviser to or to manage any investment or trading account of another person other than an investment company registered under title I of this Act.

(e) The Commission, by rule or regulation, upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person or transaction, or any class or classes of persons or transactions, from subsection (a)(1), if and to the extent that the exemption relates to an investment advisory contract with any person that the Commission determines does not need the protections of subsection (a)(1), on the basis of such factors as financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, and such other factors as the Commission determines are consistent with this section. With respect to any factor used in any rule or regulation by the Commission in making a determination under this subsection, if the Commission uses a dollar amount test in connection with such factor, such as a net asset threshold, the Commission shall, by order, not later than 1 year after the date of enactment of the Private Fund Invest-

ment Advisers Registration Act of 2010, and every 5 years thereafter, adjust for the effects of inflation on such test. Any such adjustment that is not a multiple of \$100,000 shall be rounded to the nearest multiple of \$100,000.

(f) **AUTHORITY TO RESTRICT MANDATORY PRE-DISPUTE ARBITRATION.**—The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any investment adviser to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.

\* \* \* \* \*

## MINORITY VIEWS

H.R. 5424 seeks to provide regulatory relief to investment advisers to private funds, particularly private equity funds, which would reduce transparency and make it harder for the Securities and Exchange Commission (SEC) to protect investors in those funds. The bill also fails to address the needs of investors for greater protections and disclosures, as evidenced by recent SEC exams and enforcement actions.

In the Dodd-Frank Act, we sought to bring transparency and oversight over the shadow banking system, particularly for private equity funds and hedge funds. Specifically, we required advisors to these funds with more than \$150 million in assets to register with the SEC, comply with new recordkeeping, reporting, and audit requirements, and file systemic risk reports with the Financial Stability Oversight Council (FSOC).

H.R. 5424 would change this new regime by removing important investor protections including the requirements that such advisers: notify clients of a change in ownership or control of the adviser; deliver a plain language narrative brochure to clients each year; and disclose to the FSOC certain information on large private equity funds. Worse, H.R. 5424 would create a Madoff loophole by providing a broad exemption from the annual audit requirement for funds owned by investors who may have a tangential relationship with the adviser, such as a caterer or building manager.

H.R. 5424 is also problematic because it fails to address the problems that the SEC has uncovered as a result of its new oversight of private fund advisers. In 2013, the SEC found that in cases where it examined how fees and expenses are handled, it identified violations of law or material weaknesses in controls over 50% of the time. In 2014 and 2015, the SEC brought numerous enforcement actions against private equity fund managers for: misallocating expenses to funds; failing to disclose loans from clients; using funds to pay their operating expenses without authorization and disclosure; and failing to disclose fees and discounts from service providers. Finally, last month, the SEC Director of Enforcement highlighted a need for greater transparency into fees and expenses.

Considering that one-quarter of the equity in private equity funds comes from public pension funds—who invest on behalf of our nation’s teachers, police officers and firefighters—we should not be repealing important protections and failing to address the need for additional protections. CalPERS, the largest public pension fund in the U.S.; CalSTRS, which provides retirement benefits to California’s public school teachers; and the Institutional Limited Partners Association, which represents a large swath of investors in private equity funds, agree and oppose H.R. 5424.

For all of these reasons, we oppose H.R. 5424.

MAXINE WATERS.  
EMANUEL CLEAVER.  
STEPHEN LYNCH.  
KEITH ELLISON.  
GWEN MOORE.  
AL GREEN.  
WM. LACY CLAY.

