SHEARMAN & STERLING LLP

Client Publication

Asset Management | October 6, 2009

New Developments on U.S. Legislative Proposals for the Registration of Advisers to Private Funds

Ending several months of legislative silence on private fund manager registration, Representative Paul Kanjorski, Chairman of a sub-committee of Representative Barney Frank's House Financial Services Committee, released an October 1, 2009 "discussion draft" of the Private Fund Investment Advisers Registration Act. Except for a carve-out for the venture capital industry, this latest proposal is substantially similar to that sent to Congress by the Treasury Department in June.[1] The new draft appears to be the first step towards formally introducing a bill on the topic and fits with recent public remarks by Representative Frank that the House of Representatives will act on such a bill before year-end. There is less corresponding activity in the Senate, suggesting that the final legislation may still slip into next year. There also continues to be silence on what type of post-legislation grace period will be allowed during which the Securities and Exchange Commission and the fund industry can arrange an orderly transition to a new, broadly mandatory registration regime.

New Registration Requirements

The proposed legislation would amend Section 203 of the Investment Advisers Act of 1940, as amended, to remove Section 203(b)(3) – the so-called "private adviser" or "fourteen-or-fewer client" exemption from investment adviser registration. The result will be to require that most private fund managers register as investment advisers with the SEC.

Highlighting stridency in Congress on anything perceived as a loophole from regulation, Representative Kanjorski's view on the existing exemption is stated pointedly on his website: "[A]dvisers to hedge funds, private equity firms and other private pools of capital skirt government oversight and get away like bandits…"

Foreign Private Fund Advisers

The proposed legislation provides an exemption to the registration requirement for a "foreign private fund adviser," defined as an investment adviser who: (i) has no place of business in the United States; (ii) during the preceding 12 months had (x) fewer than 15 clients in the United States and (y) assets under management attributable to clients in the United States of less than $25 million (or a higher amount as the SEC deems appropriate); and (iii) does not hold itself out to the public in the United States as an investment adviser, and does not act as an investment adviser to a registered

[1] The Treasury Proposal is available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. The Treasury Proposal is discussed in our earlier Client Alert (dated July 22, 2009), available at http://www.shearman.com/Obama-Administration-Proposes-Investment-Adviser-Legislation-to-US-Congress/.

investment company or a business development company.

The degree to which the proposed legislation would "look through" to U.S. investors in non-U.S. funds for purposes of these client-count and asset-threshold tests is unclear, but some degree of look-through is widely expected. This would mean that many non-U.S. fund managers currently exempt from U.S. registration will lose that exemption.

Venture Capital Fund Advisers

Suggesting that parts of the fund industry continue to actively (and in this case successfully) lobby Congress for carve-outs, the proposed legislation provides a new, partial exemption for an adviser to a "venture capital fund," which the proposed legislation instructs the SEC to define. An adviser to a venture capital fund would be exempt from registration, but must maintain records and provide reports to the SEC as the SEC determines necessary or appropriate to protect investors. It does not look likely, however, that this carve-out would apply to the broader private equity and buyout industries, as publicity accompanying Representative Kanjorski's proposal continues to say that private equity fund managers would be required to register.

Others To Be Singled Out for Special Treatment?

The proposed legislation contains more explicit language than the earlier Treasury proposal to the effect that the SEC can vary the reporting and other regulatory requirements of advisers based on the types or sizes of private funds advised by such advisers or other differences in their business models. That and other broad, proposed grants of interpretive authority to the SEC will empower the SEC, if it so chooses, to provide for exemptions or other relief to particular parts of the private fund industry (e.g., non-U.S. managers with especially limited U.S. contacts). Of course, that authority also would allow the SEC to select parts of the industry for still more intrusive regulation than that hinted at to date.

New Reporting Requirements

Under the proposed legislation, the SEC is authorized to require a registered investment adviser to maintain records and file reports containing information about each "private fund" it advises, including each fund's: (i) amount of assets under management; (ii) use of leverage; (iii) counterparty credit risk exposures; (iv) trading and investment positions; (v) trading practices; and (iv) other information the SEC deems necessary and appropriate in the public interest and for the protection of investors or the assessment of systemic risk.

A "private fund" is defined in the proposed legislation as an investment fund that (i) relies on either the Section 3(c)(1) or 3(c)(7) exception to the definition of an investment company, and (ii) either (x) is organized or created under the laws of the United States or of a state, or (y) has more than 10% of its securities owned by U.S. persons.

In Representative Kanjorski's words, these new reports will give "regulators the information needed to evaluate both individual firms and entire market segments that have until this time largely escaped any meaningful regulation…"

The Other Discussion Drafts

The draft of the proposed legislation was one of three drafts Representative Kanjorski released on October 1, 2009, the other two being those relating to investor protection generally and insurance regulation. The draft Investor Protection Act of 2009 is a true grab-bag of proposals, which we will be summarizing in a separate client alert, but it includes the following elements that will directly impact investment advisers:

- doubling the SEC's funding over 5 years;
- giving the SEC power to ban mandatory arbitration clauses;
- establishing a fiduciary standard for all financial intermediaries who provide investment advice to their customers; and

- creating a whistleblower bounty program to create incentives to report wrongdoing.

Next Steps

Representative Kanjorski's proposed bill is just a draft and has not been formally introduced. There is thus room for continued lobbying and reconsideration, although the ultimate enactment of legislation substantially in this form is widely anticipated – not least because there is no organized, broad-based industry opposition at this point.

Congressional hearings are picking up again as well, with key industry groups appearing before Representative Frank's committee today. But little will be understood about final timing until the Senate signals its schedule and Congress or the SEC begins to speak to a post-legislative implementation timetable.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Nathan J. Greene
New York
+1.212.848.4668
nathan.greene@shearman.com

Azam H. Aziz
New York
+1.212.848.8154
azam.aziz@shearman.com

Laura S. Friedrich
New York
+1.212.848.7411
lfriedrich@shearman.com

Donna M. Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Barnabas W.B. Reynolds
London
+44.20.76555528
barney.reynolds@shearman.com

Bradley K. Sabel
New York
+1.212.848.8410
bsabel@shearman.com

Paul S. Schreiber
New York
+1.212.848.8920
paul.schreiber@shearman.com

Bill Murdie
London
+44.20.76555149
bill.murdie@shearman.com

M. Holland West
New York
+1.212.848.4579
hwest@shearman.com

Lorna X. Chen
Hong Kong
852.2978.8001
lorna.chen@shearman.com

Richard H. Metsch
New York
+1.212.848.7518
richard.metsch@shearman.com

John Adams
London
+44.20.76555740
john.adams@shearman.com

Amy E. Bohannon
New York
+1.212.848.4347
abohannon@shearman.com

Jesse P. Kanach
Washington DC
+1.202.508.8026
jesse.kanach@shearman.com

J.D. Siegel
New York
+1.212.848.7304
jd.siegel@shearman.com

©2009 Shearman & Sterling LLP. As used herein, "Shearman & Sterling" refers to Shearman & Sterling LLP, a limited liability partnership organized under the laws of the State of Delaware.