

Asset Management | June 1, 2010

Private Fund Manager Registration as U.S. Financial Reform Legislation Approaches the Finish Line

It has been widely reported that U.S. financial reform legislation is now in its final stages, as the Senate and House of Representatives are forming their “conference committee” that will work to address differences between the Senate and House bills. Among the many provisions to be reconciled in the 1,600+ pages of each bill are those that would require private fund managers to register as investment advisers with the U.S. Securities and Exchange Commission. The registration provisions would strike the existing registration exemption on which many fund managers now rely, that being the so-called “private adviser” or “fourteen or fewer clients” exemption. The result is that many fund managers that are currently exempt from SEC investment adviser registration will be forced to register in due course.

With that background, this alert highlights differences between the Senate and House treatment of these registration requirements.¹ We continue to monitor developments as this legislation moves forward.

As to timing, the Democrats’ stated goal is to have this reform bill signed into law before the 4th of July. Both the House and Senate financial reform bills then call for the investment adviser registration provisions to be effective one year after the law is signed by the President. This means that, were a final bill signed into law June 30, 2010, the registration requirement would be effective June 30, 2011. To meet that deadline, investment adviser registration applications would need to be filed with the SEC by May 15, 2011.

¹ Shearman & Sterling has written extensively on the financial regulatory reforms that are now part of the proposed legislation. Our most recent writing is a broad look at the Senate bill and upcoming Senate-House conference session, which we posted to our website today as a companion piece to this alert. That companion alert and other alerts you may find of interest include the following (all dates are 2010 except as indicated and all are available through www.shearman.com/publications)

- June 1, House-Senate Conference to Reconcile Financial Regulatory Reforms Bills
- April 2, U.S. Senate Banking Committee Approves a Sweeping Financial Regulatory Reform Bill
- Mar. 24, Global Financial Regulatory Reform Proposals: An Overview
- Dec. 22, 2009, U.S. House of Representatives Passes Wall Street Reform Bill: A Preliminary Analysis
- Dec. 14, 2009, U.S. Legislative Update: Why Real Estate Fund Managers Should Monitor Congressional Bills Targeted at Hedge Funds
- Oct. 6, 2009, New Developments on U.S. Legislative Proposals for the Registration of Advisers to Private Funds

Principal differences in how the House and Senate bills would address fund manager registration

\$100 million or \$150 million

Both bills try to limit what will be a flood of new required registrations with the SEC by shunting a larger group of investment advisers to state-level supervision. Under the Senate bill, an adviser may not register with the SEC unless it has at least \$100 million under management (up from the current \$25 million). The House bill takes a different approach, providing a new exemption for an adviser solely of private funds (for example, managing no separate accounts) who has assets under management in the United States of less than \$150 million. Smaller investment advisers falling below these thresholds will have to register with states.

Private equity, venture capital, family offices

U.S. hedge fund managers appear certain to become required to register. Exemptions have been put forth, however, for advisers of private equity, venture capital and family office businesses.

- **Private equity:** The Senate (but not the House) would exempt private equity fund managers from the requirement to register with the SEC and be substantively regulated. The Senate bill would, however, impose obligations on private equity fund managers to make reports to the SEC and keep records.
- **Venture capital:** Both the House and Senate bills would exempt venture capital firms from the requirement to register with the SEC and be substantively regulated. The House bill would, however, impose obligations on venture capital fund managers to make reports to the SEC and keep records.
- **Family offices:** The Senate bill would exclude family offices from the definition of investment adviser. Some parts of the U.S. Investment Advisers Act of 1940 (Advisers Act) apply to all persons that meet the definition of “investment adviser,” even if they are exempt from registration. Those parts of the Act would not apply to family offices under the Senate bill. The House bill has no similar carve-out for family offices.

The SEC would define “private equity fund,” “venture capital fund” and “family office” as appropriate. The SEC would also determine the extent of the reporting requirements described above, and it is unclear how heavy the reporting burden would be.

Global effect

The final legislation is expected to have broad extraterritorial effect and result in the SEC registration of many non-U.S. investment advisers. The key (but narrow) exemption for non-U.S. advisers is a new “foreign private adviser” exemption. Both the Senate and House bills provide for that exemption but have significant differences.

In summary, the foreign private adviser exemption under each bill would be available to a non-U.S. adviser that has no place of business in the United States, does not exceed the \$25 million assets-under-management (AUM) and 14 U.S. clients thresholds discussed below, and does not hold itself out generally to the public in the United States as an investment adviser.

- **No place of business:** Both bills have the same provision. We expect that whether an adviser has a place of business in the United States will be read broadly.

- What does the \$25 million AUM threshold measure? Each bill expressly includes investors in the United States in private funds in that calculation.
- At what point is the threshold exceeded for number of U.S. clients? First, as with the AUM threshold, the House version expressly counts clients and investors in the United States in private funds. The Senate version counts clients who are domiciled in or residents of the United States. As it does not expressly count fund investors, the Senate provision would benefit more managers, unless the definition of “client” is later expanded to include fund investors for this purpose. See the discussion of the definition of “client” below. Second, the House version counts clients and fund investors over the preceding 12 months, while the Senate version counts only current clients.
- No holding out publicly in the United States: Both bills have the same provision.

Non-U.S. advisers should monitor whether the SEC will implement a “registration lite” regime for them (as it did during the course of its earlier, failed bid to require registrations), but there is no indication that is coming at this time. Perhaps on a related note, the House bill calls for the SEC to take account of the relative risk profiles of private funds as it implements registration requirements, and authorizes the SEC to condition additional reporting requirements based on type of fund.

Non-U.S. advisers also have long been able to leverage a U.S. affiliate’s registration in lieu of registering the non-U.S. business (under the so-called Unibanco guidance). This appears to still be an option.

Who is a fund manager’s “client”?

The Advisers Act imposes clear duties on investment advisers with respect to their “clients” – which, for the most part, include funds and exclude fund investors under current law. As a fund’s investors have conflicting interests with each other, it is often not practicable to comply with a duty to each particular fund investor. The House bill would prohibit the SEC from defining “client” to include investors in a private fund that has entered into an investment advisory contract. The Senate bill would grant the SEC broad authority to define terms without that prohibition, except that such a fund investor could not be defined as a client under the broad anti-fraud provisions of the Advisers Act (under Sections 206(1) and (2) of that Act).

Investor qualification standards

The accredited investor standard (relating to U.S. private placements under Regulation D) and the qualified client standard (relating to the payment of performance compensation under the Advisers Act) may be subject to adjustment after the law goes into effect. Congress is considering either an automatic periodic adjustment to certain dollar amounts under those standards to account for inflation or instructing the SEC to consider appropriate adjustments periodically. Fund offering and subscription documents will, of course, need to be revised as the standards are adjusted.

Expanded recordkeeping, reporting and disclosure requirements

Each bill calls for registered investment advisers to report to the SEC on matters related to systemic risk. SEC rules will establish the framework for meeting that requirement. Each bill also requires reports to the SEC on certain aspects of each private fund's investment operations. The Senate bill identifies additional

categories of information not included in the House bill, including descriptions of the fund's valuation policies, types of assets held, and side letters. The House bill would also authorize the SEC to compel disclosure of information to a private fund's investors, creditors and counterparties (with an exclusion for certain proprietary information). It is difficult at this time to forecast the effect of SEC disclosure requirements with respect to creditors and counterparties.

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 Greene
New York
+1.212.848.4668
ngreene@shearman.com

Azam Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Laura Friedrich
New York
+1.212.848.7411
laura.friedrich@shearman.com

Geoffrey Goldman
New York
+1.212.848.4867
geoffrey.goldman@shearman.com

Donna Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Barney Reynolds
London
+44.20.76555528
barney.reynolds@shearman.com

Bradley Sabel
New York
+1.212.848.8410
bsabel@shearman.com

Russell Sacks
New York
+1.212.848.7585
russell.sacks@shearman.com

Paul Schreiber
New York
+1.212.848.8920
pschreiber@shearman.com

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

Holland West
London
+1.212.848.4579
hwest@shearman.com

Lorna Chen
Hong Kong
+852.29788001
lorna.chen@shearman.com

Richard Metsch
New York
+1.212.848.7518
rmetsch@shearman.com

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

Amy Bohannon
New York
+1.212.848.4347
amy.bohannon@shearman.com