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Obama Administration Proposes Investment Adviser Legislation to U.S. Congress

On July 15, 2009, the U.S. Department of the Treasury ("Treasury") delivered to the U.S. Congress the Private Fund Investment Advisers Registration Act of 2009 ("Proposed Legislation"), which would, among other things, require certain advisers to private investment funds to register as "investment advisers" with the U.S. Securities and Exchange Commission ("SEC") under the U.S. Investment Advisers Act of 1940 as amended ("Advisers Act").[1] The Proposed Legislation would substantially enact the investment adviser reforms recommended by the Obama Administration's U.S. financial services regulatory reform plan, released on June 17, 2009 ("Plan").[2]

Highlights of the Proposed Legislation include:

- eliminating the current private adviser exemption to SEC investment adviser registration;
- eliminating the current investment adviser registration exemption for certain commodity trading advisors ("CTAs") registered with the U.S. Commodity Futures Trading Commission ("CFTC");
- granting the SEC authority to require registered investment advisers to maintain and submit to the SEC records and reports in respect of the private investment funds advised by them; and
- permitting the SEC to define the term "client" and other terms in the Advisers Act differently for different sections of the Advisers Act.

Elimination of Private Adviser and Other Registration Exemptions

In keeping with the Obama Administration's Plan, the Proposed Legislation does *not* require private investment funds themselves to be subject to registration or regulation under the U.S. Investment Company Act of 1940 as amended ("Investment Company Act").[3] Instead, the Proposed Legislation requires SEC registration for

1 The Treasury's press release announcing the Proposed Legislation is available at http://www.treasury.gov/press/releases/tg214.htm, and contains a link to the legislative language.

2 The Plan is discussed in our earlier Client Alert (dated June 23, 2009) available at http://www.shearman.com/us-financial-regulatory-reform-investment-advisory-proposals/. The Proposed Legislation is the second of the Plan's recommendations to become proposed legislation. On July 8, 2009, U.S. Congressman Barney Frank of Massachusetts introduced H.R. 3126, entitled the Consumer Financial Protection Agency Act of 2009. That legislation is discussed in our earlier Client Alert (dated July 15, 2009) available at http://www.shearman.com/fia-071509-the-consumer-financial-protection-agency-act-of-2009/.

3 Subjecting private investment funds to Investment Company Act registration and regulation would have far greater implications than the Proposed Legislation, as the Investment Company Act subjects registered investment funds to stringent operational restrictions, including with respect to leverage, affiliate transactions, redemptions, and board independence.

investment *advisers* to "private funds"[4], as it would amend the Advisers Act and regulations thereunder to eliminate or substantially limit several registration exemptions commonly relied upon by investment advisers to private investment funds.[5]

The Proposed Legislation would:

- eliminate the current "intrastate adviser" registration exemption for any investment adviser to a private fund, amending Advisers Act Section 203(b)(1)[6];
- eliminate the current "private adviser" (or "counting clients") registration exemption amending Advisers Act Section 203(b)(3)[7], thereby requiring investment advisers to private funds with at least $30 million in assets under management to register with the SEC; and
- eliminate the current investment adviser registration exemption for certain registered CTAs who act as an investment adviser to a private fund, amending Advisers Act Section 203(b)(6).[8]

Notwithstanding the spin given to the Proposed Legislation in the media, the effect of the changes would not be limited to advisers to hedge funds. Instead, it would require SEC investment adviser registration for every investment adviser currently relying on the private adviser registration exemption, regardless of whether the adviser manages private investment funds. For example, investment advisers to family offices would be subject to the Proposed Legislation's registration requirements. As noted in the Treasury's press release, the Proposed Legislation is intended to make the registration requirements apply to investment advisers to venture capital funds and private equity funds (among others). Some commentators have argued that these vehicles pose less systemic risk than hedge funds and therefore their managers should be exempt from the SEC investment adviser registration requirements.[9]

Registration under the Advisers Act would subject presently unregistered investment advisers to the full panoply of the requirements of the Advisers Act and regulations thereunder, including in regard to: advisory contracts; advisory fees; fiduciary duties and standards of care to clients; disclosure to clients and regulators; custody and possession of client assets; recordkeeping; advertising; trading and investment practices; supervision, compliance, and code of ethics practices, policies, and procedures; use

[4] This term (defined in the Proposed Legislation) is discussed in the section below entitled "Private Investment Fund Reporting".

[5] On June 16, 2009, U.S. Senator Jack Reed of Rhode Island introduced S. 1276, entitled the Private Fund Transparency Act of 2009, a bill with strong similarities to, but less far-reaching than, the Proposed Legislation. The text of the bill is available at http://www.govtrack.us/congress/billtext.xpd?bill=s111-1276.

[6] Section 203(b)(1) provides a registration exemption for an investment adviser all of whose clients are residents of the State within which such adviser maintains his principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange.

[7] Section 203(b)(3) provides a registration exemption for an investment adviser who during the course of the preceding 12 months has had fewer than 15 clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to an investment company registered, or a company electing business development company status, under the Investment Company Act. Advisers Act Regulation 203(b)(3)-1 further clarifies this registration exemption by providing generally that a private investment fund organized as an entity or other legal organization may be treated as a single client of an investment adviser if such fund receives investment advice based on its investment objectives rather than the individual investment objectives of the fund's investors.

[8] Section 203(b)(6) provides a registration exemption for an investment adviser that is a CTA registered with the CFTC whose business does not consist primarily of acting as an investment adviser to an investment company registered, or a company electing business development company status, under the Investment Company Act.

[9] In January 2009, the "Group of 30"—an international committee of current and former senior regulators and bankers—endorsed the idea of subjecting some mangers of private pools of capital to registration requirements, but would have limited those registration requirements to managers of private pools of capital employing substantial leverage. A significant difference between the Group of 30 proposal and the Proposed Legislation is that the Group of 30 would have exempted from registration managers of venture capital funds, presumably due in part to their lesser reliance on leverage. The Group of 30 proposal is discussed in our earlier Client Alert (dated January 30, 2009), available at http://www.shearman.com/am_013009/.

of solicitors and placement agents; and SEC inspections, discipline, and disqualification.

Effect on Certain Non-U.S. Investment Advisers

The Proposed Legislation would exempt certain non-U.S. investment advisers from the Advisers Act's registration requirements. The Proposed Legislation defines a "foreign private adviser" as an investment adviser who:

- has no place of business in the United States;
- during the preceding 12 months has had fewer than 15 clients in the United States and assets under management attributable to U.S. clients of less than $25 million (or such higher amount as the SEC may deem appropriate); and
- neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to an investment company registered, or a company electing business development company status, under the Investment Company Act.

The Proposed Legislation's effect on non-U.S. investment advisers likely would be significant. The Proposed Legislation requires that a non-U.S investment adviser have *no place of business* in the United States in order to qualify for the foreign private adviser exemption, whereas prior SEC guidance allowed for a registration exemption for a non-U.S adviser having a *principal place of business* outside of the United States and fewer than 15 U.S. clients. Additionally, assuming that U.S. client assets under management includes for this purpose investments in private funds and assuming a look-through to fund investors when counting clients (both of which assumptions reflect reasonably predictable, but not certain, features of the final legislation and any follow-on SEC rulemaking), a non-U.S. investment adviser with even relatively limited scope U.S. relationships (even those existing only by virtue of having U.S. investors in non-U.S. funds) could be outside the Proposed Legislation's definition of, and exemption for, a foreign private adviser, and therefore would be subject to the Advisers Act investment adviser registration and regulation requirements. Perhaps most troubling, at least in this regard, is that the Proposed Legislation appears to disqualify a non-U.S. investment adviser from this exemption if it has *either* 15 or more U.S. clients *or* $25 million or more in U.S. client investments. For example, even one institutional U.S. client mandate would likely exceed the $25 million threshold. Unless the Proposed Legislation is modified or the SEC by regulation changes the threshold, the number of non-U.S. investment advisers registered with the SEC (or turning away U.S. business) could be a startling side effect of the Proposed Legislation.

Private Investment Fund Reporting

The Proposed Legislation defines a "private fund" as an investment fund that (1) would be an investment company under the Investment Company Act but for Section 3(c)(1) or 3(c)(7) thereof, and (2) either is organized or otherwise created under the laws of the United States or any State or has 10 percent or more of its outstanding securities owned by U.S. persons. The Section 3(c)(1) and 3(c)(7) exclusions from investment company status under the Investment Company Act are customarily utilized by hedge funds, private equity funds, buyout funds, venture capital funds, certain real estate funds, funds of funds, and certain CDO and other securitization commingled investment vehicles. A non-U.S. domiciled private investment fund having less than 10 percent U.S. ownership would appear to not constitute a private fund and thus not subject the investment adviser or fund to the requirements of the Proposed Legislation and Advisers Act, although the fund would still need to qualify for an exclusion from investment company status under the Investment Company Act in respect of its U.S. investors.

Although the Proposed Legislation does not require private funds to register as investment companies, it does employ the investment adviser registration requirements to gain access to certain documents, records, reports, and other information in respect of private funds. The Proposed Legislation grants the SEC authority under the

Advisers Act to require any registered investment adviser to maintain records regarding the private funds it advises and submit reports to the SEC, as is necessary or appropriate in the public interest and for the assessment of systemic risk by the SEC, the Board of Governors of the U.S. Federal Reserve System ("Federal Reserve"), and the proposed Financial Services Oversight Council ("Council").[10] This is a potentially sweeping grant of authority.

Those records and reports would initially include (without limitation) information regarding assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading and investment positions, and trading practices, as well as other information the SEC, in consultation with the Federal Reserve, deems necessary or appropriate in the public interest to assess systemic risk. Additionally, the SEC could require a registered investment adviser to disclose the identity, investments, and affairs of any of its clients.[11] All such records, reports, documents, and other information would be subject to maintenance by a registered investment adviser and to periodic, special, or other examination by the SEC.

Apparently in recognition of the sensitivity of the foregoing information, the Proposed Legislation provides that the SEC could not be compelled to disclose any supervisory report or other information required to be filed with it. However, the SEC could not withhold information from the U.S. Congress or fail to comply with requests for information from other U.S. federal regulatory authorities or self-regulatory authorities or U.S. federal courts exercising proper jurisdiction. On the other hand, potentially taking away the "zone of privacy" that is expected for this information, the SEC may further require that a registered investment adviser provide such records, reports, and other documents to investors, prospective investors, counterparties, and creditors of any private fund advised by it.

The Proposed Legislation allows the SEC to provide the foregoing information to the Federal Reserve and the Council, so that they may determine the systemic risk of a private fund or whether a private fund should be designated a Tier 1 Financial Holding Company ("Tier 1 FHC"). The Proposed Legislation provides that all such reports, documents, records, and other information obtained by the Federal Reserve or the Council shall be kept confidential. As discussed in our earlier client alert, the Federal Reserve, in its capacity as systemic risk regulator, would designate as a Tier 1 FHC any firm whose failure would pose a systemic risk, based on factors such as size, use of leverage, and interconnectedness. Any Tier 1 FHC would be subject to the consolidated supervision of the Federal Reserve and would be subject to more stringent requirements than even Bank Holding Companies.[12]

Classification of Clients…and Potentially Much More

The Proposed Legislation provides that the SEC by regulation may (i) classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters, and (ii) ascribe different meanings to terms (including the term "client") used in different sections of the Advisers Act and regulations thereunder. We would expect lobbying of, and commentary to, the U.S. Congress and the SEC by certain constituencies affected by the Proposed Legislation in order to eliminate or limit its impact on them or their businesses.

The Proposed Legislation would specifically grant the SEC the authority to ascribe different meanings to the term "client". The backdrop to that emphasis is *Goldstein*

[10] The creation of a Council was proposed by the Plan. This new Council would be comprised of the heads of the most important U.S. financial regulators and would advise the Federal Reserve regarding the Federal Reserve's proposed new role as the systemic risk regulator.

[11] The Proposed Legislation would grant this authority to the SEC by deleting Section 210(c) of the Advisers Act.

[12] See Footnote 2 above. See also our earlier Client Alert (dated June 23, 2009) available at http://www.shearman.com/fia-062309-us-financial-regulatory-reform-implications-for-banking-institutions/.

v. SEC, the 2006 decision of the U.S. Court of Appeals for the District of Columbia that struck down the SEC's "hedge fund rule".[13] That rule would have required investment advisers to private investment funds to register as investment advisers with the SEC under the Advisers Act. The SEC had reasoned that investors in the advised fund should be counted as clients of the investment adviser, thereby denying the private adviser exemption to many advisers to private investment funds. In ruling against the SEC, the court reasoned in part that "client" should not mean one thing when determining to whom fiduciary duties are owed (the fund advised), and another when determining an adviser's eligibility for the private adviser exemption under the Advisers Act. In the Proposed Legislation, the proposed grant of broad interpretive and rulemaking authority to the SEC indicates that more is at stake than the overturning of *Goldstein*.

Going Forward

The Proposed Legislation is the second facet of the Obama Administration's Plan that has been delivered to the U.S. Congress.[14]

Viewed through the lens of private funds, a key take-away is that the Proposed Legislation would not require registration of private funds themselves, but would subject investment advisers to private funds to a more regulated framework than the one in which they currently operate. Nonetheless, the Obama Administration's approach to the regulation of investment advisers to private funds represents a lighter touch than that put forward by the European Commission ("EC").[15] The EC's draft proposal would subject investment advisers to minimum capital requirements, create additional sources of adviser liability, and restrict the ability of advisers desiring to appoint administrators or valuers of fund assets domiciled outside of the European Union.

Viewed through the lens of the unregistered investment adviser industry more generally, and especially its non-U.S. component, the Proposed Legislation offers anything but a light touch. The same can be said of the regulatory framework still to be developed and of the proposed broad interpretive and rulemaking authority that would be granted to the SEC. Such proposed authority applies throughout the Advisers Act and could empower the SEC on a variety of rulemaking fronts.

We will continue to monitor and report on these and related proposals and counterproposals as the legislation and regulations evolve.

13 Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

14 See Footnote 2 above.

15 The EC's proposed Directive on Alternative Investment Fund Managers, released in April 2009, is discussed in our earlier Client Alert (dated May 5, 2009), available at http://www.shearman.com/fia-050509-updated-new-european-proposals-for-the-regulation-of-alternative-investment-fund-managers/.

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:

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

Steven R. Blau
New York
+1.212.848.8534
steven.blau@shearman.com

Nathan J. Greene
New York
+1.212.848.4668
ngreene@shearman.com

Paul S. Schreiber
New York
+1.212.848.8920
pschreiber@shearman.com

Richard H. Metsch
New York
+1.212.848.7518
rmetsch@shearman.com

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

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

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

Russell D. Sacks
New York
+1.212.848.7585
rsacks@shearman.com

Charles S. Gittleman
New York
+1.212.848.7317
cgittleman@shearman.com

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

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

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

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

Stephen Besen
New York
+1.212.848.8902
sbesen@shearman.com

Barnabas W.B. Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

John Adams
London
+44.20.7655.5740
john.adams@shearman.com