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www.klgates.com

Authors:

Edward G. Eisert
edward.eisert@klgates.com
+1.212.536.3905

Mark J. Duggan
mark.duggan@klgates.com
+1.617.261.3156

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The Obama Administration's Proposal for the Registration of Investment Advisers to Private Investment Funds

The Private Fund Investment Advisers Registration Act of 2009

Overview of the Proposal

On July 16, the Obama Administration introduced proposed legislation entitled the "Private Fund Investment Advisers Registration Act of 2009" (the "Proposal") to implement the regulatory reform proposals concerning investment advisers to "private pools of capital" set forth in the Treasury Department's Financial Regulatory Reform proposals (the "White Paper").[1] Under the Proposal, advisers to hedge funds and other private pools of capital, including advisers to private equity funds and venture capital funds, would be required to register with the Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940 ("Advisers Act"), subject only to limited exceptions. Additionally, the Proposal would impose on such registered advisers increased recordkeeping, disclosure and reporting obligations related to the private funds they advise. The Proposal stops short of requiring the funds themselves to register with the SEC.

Registration Requirements

Under the Proposal, a "Private Fund" would be defined as any investment fund that is excluded from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 ("Company Act") and either: (i) is organized or otherwise created under U.S. federal or state law; *or* (ii) has 10% or more of its outstanding securities owned by "U.S. persons" (a term which is not defined).[2] Generally, except as discussed below, any adviser to a Private Fund would be required to register under the Advisers Act.

A new exception from registration would be provided for a "Foreign Private Adviser," *i.e.*, an adviser that comes within the existing exemption from registration provided to "private advisers" under Section 203(b)(3) of the Advisers Act (the "Private Adviser Exemption"),[3] and has no place of business in the U.S., does not

[1] *See "Financial Regulatory Reform, A New Foundation," U.S. Department of the Treasury, June 17, 2009.*

[2] In other instances, the SEC has used the definition of "U.S. person" set forth in Rule 902 of Regulation S promulgated under the Securities Act of 1933 when a definition of "U.S. person" is required. *See, e.g.,* Rule 500 of Regulation AC promulgated under the Securities Exchange Act of 1934.

[3] Section 203(b)(3) of the Advisers Act provides an exemption from registration to:

> any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients [none of which is a registered investment company or business development company, registered as such under the Company Act] and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any [investment company registered under the Company Act] . . . .

hold itself out as an investment adviser in the U.S., and during the preceding 12 months had "assets under management attributable to clients in the United States of less than $25,000,000, or such higher amount as the [SEC] may, by rule, deem appropriate in accordance with the purposes of [the Advisers Act]."

A more far reaching aspect of the Proposal would be the rescission in its entirety of the Private Adviser Exemption, *e.g*., without regard to the characteristics of the clients of an adviser or the amount of its assets under management ("AUM").

The Proposal would also eliminate the exemption from registration under the Advisers Act for certain commodity trading advisors registered with the Commodity Futures Trading Commission ("CFTC"), if the commodity trading advisor acts as an investment adviser to a Private Fund.

Recordkeeping, Reporting and Disclosure Requirements

The Proposal would give the SEC authority to require a registered adviser to a Private Fund to comply with increased regulatory recordkeeping requirements, reporting requirements and mandatory disclosure obligations to investors, creditors and counterparties. In particular, the Proposal would require that an adviser to a Private Fund report on a confidential basis, at a minimum, the Private Fund's AUM, use of leverage (including off-balance sheet leverage), counterparty risk exposures, trading and investment positions, and trading practices. The SEC would have authority to conduct regular, periodic examinations of the adviser to monitor compliance with these requirements and would have authority to provide the information obtained to the Board of Governors of the Federal Reserve System and the Financial Oversight Council on a confidential basis for the purpose of assessing the systemic risk of a Private Fund or assessing whether a Private Fund should be designated a "Tier 1 FHC." Under other aspects of the White Paper, Tier 1 FHCs would be subject to, among other things, supervision by the Federal Reserve as well as higher capital, liquidity and risk management standards.

The Proposal also would require the SEC and CFTC, after consultation with the Board of Governors of the Federal Reserve System, within six months after enactment of the Proposal, jointly to promulgate rules to establish the form and content of the reports required to be filed by advisers that are registered under both the Advisers Act and the Commodity Exchange Act.

Finally, the Proposal would grant the SEC far reaching authority to "classify persons and matters," to prescribe different requirements for different classes of persons and matters, and to ascribe different meanings to various terms used in the Advisers Act (including the term "client"), as the SEC determines to be necessary to effect its purposes. These provisions would give the SEC the power to craft different rules or regimes governing advisers to hedge funds, private equity funds, and venture capital funds.

Far Reaching Consequences of the Proposal

Overview

Viewed from a high level, enactment of the Proposal would achieve two of the primary objectives set out in the White Paper, *i.e.,* to subject to regulatory oversight "financial institutions [including hedge funds and other private pools of capital] that are critical to market functioning [and] allow data to be collected that would permit an informed assessment of how such funds are changing over time and whether any such funds have become so large, leveraged, or interconnected that they require regulation for financial stability purposes." Also, it is fair to say that the Proposal would cause somewhat less disruption to the complex and well-developed regulatory scheme under the Advisers Act and Company Act than some alternative proposals that call for the rescission of Section 3(c)(1) or Section 3(c)(7) of

the Company Act ("Section 3(c)(1)" and "Section 3(c)(7)," respectively) or conditioning an exemption from registration under the Company Act upon compliance with numerous requirements.[4]

Nonetheless, in seeking to implement the White Paper's goals, the Proposal goes farther than would be expected by: (i) rescinding in its entirety the Private Adviser Exemption for U.S. advisers; (ii) failing to distinguish between hedge funds and other types of Private Funds, such as private equity funds and venture capital funds; (iii) failing to address the important issues presented with respect to non-U.S. domiciled and managed Private Funds; (iv) providing only a *de minimis* private adviser exemption for foreign advisers; and (v) authorizing substantially greater recordkeeping, reporting and disclosure requirements for advisers to Private Funds.

Elimination of the Private Adviser Exemption

The Proposal would rescind the Private Adviser Exemption in its entirety, rather than taking an approach focused on systemically significant funds, such as could be accomplished by "looking through" funds to count each investor therein as a "client" for purposes of the Private Adviser Exemption (as reflected in Rule 203(b)(3)-2 adopted by the SEC, but subsequently vacated by the *Goldstein* decision of the D.C. Circuit Court of Appeals[5]).

Consequently, any U.S. investment adviser (whether it advises Private Funds or not) would be subject to the registration requirements of the Advisers Act, unless it comes under one of the other narrow exemptions provided for advisers under Section 203 of the Advisers Act[6] or, under Section 203A of the Advisers Act and Rule 203A-1 promulgated thereunder, it is not required to register because it has AUM of less than $30,000,000 and has its principal place of business in a state that has enacted an investment adviser statute.[7] Included would be investment advisers such as advisers to family offices that typically rely on the Private Adviser Exemption. The Administration did not explain how requiring the registration of such advisers would be necessary to achieve the objectives set out in the White Paper relating to either financial stability and systemic risk, or investor protection.[8]

Types of Funds Covered

The Proposal does not distinguish between hedge funds and other types of "private pools of capital," including traditional venture capital funds and private equity funds. The Administration asserted in the White Paper that "[a]t various points in the

[4] *E.g.,* in contrast to the Proposal, the "Hedge Fund Transparency Act," introduced by Senators Charles Grassley and Carl Levin, proposes to regulate Private Funds by rescinding Section 3(c)(1) and Section 3(c)(7) and substituting exemptions from the provisions of the Company Act for Private Funds with AUM of less than $50 million. Private Investment Funds with AUM of $50 million or more would be exempt from the provisions of the Company Act only if they registered with the SEC, filed an annual information statement, and complied with certain information and examination requirements.

[5] *Goldstein v. SEC,* 451 F.3d 873 (D.C. Circuit, June 23, 2006).

[6] *E.g.*, Section 203(b)(2) provides an exemption from registration for an investment adviser whose only clients are insurance companies.

[7] Section 203A of the Advisers Act provides that:

> no investment adviser that is regulated or required to be regulated as an investment adviser in the State in which it maintains its principal office and place of business shall register under [the Advisers Act], unless the investment adviser – (A) has assets under management of not less than $ 25,000,000, or such higher amount as the [SEC] may, by rule, deem appropriate in accordance with the purposes of [the Advisers Act]; or (B) is an adviser to an investment company registered under [the Company Act].

Under Advisers Act Rule 203A-1(a)(1), if an adviser to a Private Fund maintains its principal office and place of business in a state that has enacted an investment adviser statute, it is not required to register with the SEC unless it has AUM of $30,000,000. Under Advisers Act Rule 203A-1(a)(2), an adviser to a Private Fund that has more than $25,000,000, but less than $30,000,000 AUM, is permitted to register with the SEC, if the state in which the adviser maintains its principal place of business has enacted an investment adviser statute. Consequently, registration is optional for certain investment advisers that have between $25,000,000 and $30,000,000 AUM.

[8] The White Paper asserts that "it has also become clear that there is a compelling investor protection rationale to fill the gaps in the regulation of advisors and the funds that they manage."

financial crises, deleveraging by hedge funds contributed to the strain on financial markets. Since these funds were not required to register with regulators, however, the government lacked reliable, comprehensive data with which to assess this sort of market activity." However, the Administration did not cite specific threats to financial stability or systemic risk presented by private equity or venture capital funds or otherwise provide a rationale for treating investment advisers to venture capital and private equity funds the same way as advisers to hedge funds.

The investment programs of hedge funds, which are not formally defined by law, span a very broad range. Hedge funds can be distinguished categorically, however, from venture capital or private equity funds. Traditional venture capital and private equity funds: (i) generally make a limited number of large (relative to the aggregate capital commitments of their investors), illiquid investments in non-publicly traded operating companies; (ii) often take controlling stakes in companies or otherwise seek to exercise management rights; and (iii) require investors to forgo redemption rights for up to 10 years or more. The primary distinguishing characteristics of hedge funds are that: (i) they provide investors periodic (generally, no less frequently than annual) redemption rights; (ii) their primary investment objective is to invest opportunistically in a relatively liquid portfolio of securities and other investment assets (typically relying on some form of proprietary alternative investment strategy such as hedging, arbitrage or macro investing); and (iii) they commonly employ leverage. Therefore, one can argue that certain hedge funds that seek to profit from short-term, highly leveraged trading strategies could pose meaningful risks to the financial markets; however, the same concerns do not arise from private equity and venture capital funds. Moreover, the Advisers Act regulatory scheme is tailored to the operations of traditional managers and advisers rather than those who manage operating businesses. As result, it is not at all clear what rules, disclosures or recordkeeping and reporting requirements this legislation would justifiably impose on private equity and venture capital fund managers.

Foreign Funds and Foreign Advisers

The definition of a Private Fund would include funds organized outside of the U.S. and managed by non-U.S. advisers, if as little as 10% of the interests in such funds are owned by U.S. persons, without regard to the investment program of the fund. For example, a fund organized in the Cayman Islands, managed by an adviser that has its only place of business in the U.K. and invests all of its assets in securities that are not traded on U.S. markets would be a Private Fund, if 10% of the shares or interests in such fund are owned by U.S. persons. Under these circumstances, the U.K.-based adviser would be required to register, unless it qualifies as a Foreign Private Adviser. If it is required to register and it shares personnel and obtains other services from non-U.S. regulated affiliates, then issues would be presented as to the extent to which the requirements of the Advisers Act would apply to the non-U.S. operations, clients or accounts managed or serviced by such non-U.S. regulated affiliates.[9]

In addition, the Proposal could impose duplicative or conflicting regulatory requirements on managers of investment funds that have their principal office and place of business outside the U.S., make a public offering of their securities in another country and are regulated as public investment companies under the laws of another country.[10] Such funds typically are sold to non-U.S. persons, are invested to a large or predominant degree in securities and derivatives in non-U.S. markets, and to the extent they are invested in securities and derivatives in U.S. markets, are subject to the recordkeeping and reporting requirements of the Securities Exchange Act of 1934 ("Exchange Act").[11] Notwithstanding their limited impact on U.S. markets or persons, a non-U.S. adviser to a Private Fund that has these characteristics would become subject to an overlay

[9] *See, e.g.,* Uniao de Banco de Brasileiros S.A., SEC No-Action Letter (July 28, 1992); and ABN AMRO Bank, N.V., SEC No-Action Letter (July 1, 1997).

[10] In order to address this concern with respect to the application of Section 203(b)(3), Rule 203(b)(3)-1 under the Advisers Act excludes from the definition of a "private fund" an investment company that has these characteristics and relies upon Section 3(c)(1) or Section 3(c)(7). It is unclear what impact the enactment of the Proposal would have on Rule 203(b)(3)-1.

[11] *See, e.g.,* Sections 13(d) and 13(g) of the Exchange Act and Regulation 13D-G promulgated thereunder.

of U.S. registration and regulatory recordkeeping, reporting and disclosure requirements, if it has at least one U.S. person as an investor and, therefore, relies on Section 3(c)(1) or Section 3(c)(7) (unless such adviser can qualify as a Foreign Private Adviser).

Since the primary objectives of the Proposal are to protect the U.S. financial system and U.S. investors, it is not at all clear what requirements relating to financial stability or investor protection the Proposal contemplates the SEC justifiably should be authorized to impose on the managers of these Private Funds.

Recordkeeping, Reporting and Disclosure Requirements

The Proposal would require that an adviser to a Private Fund report on a confidential basis, at a minimum, the Private Fund's AUM, use of leverage (including off-balance sheet leverage), counterparty risk exposures, trading and investment positions, and trading practices. Not all of these items are either easily definable or always useful, however. For instance, "leverage" can mean many things to many advisers – actual borrowing, gross notional leverage, net notional leverage, *etc*. Additionally, the "amount" of leverage is not always indicative of risk, as often two leveraged positions offset each other. If the Proposal is enacted in its present form, a great deal of guidance from the Staff of the SEC will be required, and it is not clear what form or direction this guidance would take.

Through proposed revisions to the Advisers Act, the Proposal also seeks to make significant changes to the disclosure requirements that would be applicable to Private Funds. At present, the offering documents of investment funds that are exempt from registration with the SEC under Section 3(c)(1) or Section 3(c)(7) are subject to the general anti-fraud provisions of the Advisers Act and the Exchange Act, but are not subject to specific disclosure requirements applicable to publicly offered funds. The Proposal would allow the SEC substantively to regulate the disclosures made to investors in Private Funds, and it is not clear how the SEC would use this authority or if it would distinguish properly between the salient features of hedge funds, private equity funds, and venture capital funds. Even more significantly, the Proposal would give the SEC the power to require and regulate disclosures by registered advisers to their funds' counterparties and creditors, but without corresponding authority to regulate the disclosures by those counterparties and creditors to funds and their advisers. This aspect of the Proposal could materially favor counter-parties and creditors as they negotiate their commercial relationships.

Conclusion

The Proposal might achieve two of the primary objectives of the Administration with respect to the regulation of private pools of capital. As discussed above, however, the Proposal goes well beyond the Administration's professed goals in several significant respects. Unless and until the Proposal is tailored to address these concerns (or implementing regulations are promulgated), there will be considerable uncertainty about how the resulting regulatory regime would affect the hedge fund, private equity and venture capital industries.

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