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Fund Manager Registration Bill Approved by House Committee

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On October 27, 2009, the House Financial Services Committee approved legislation (the "House Bill"), similar to a bill proposed by the Obama Administration in July as a part of its broader push for financial regulatory reform, that would require the registration of many private fund managers under the Investment Advisers Act of 1940 (the "Advisers Act"). The House Bill, which is titled the "Private Fund Investment Advisers Registration Act of 2009", is different from the Obama Administration's legislation, however, in that it also contains four new exceptions to the registration requirement. The House Bill also contains important changes to the reporting requirements applicable to registered fund managers.

The key change to existing law contained in the House Bill is the removal of the popular "private advisers" exception to the Advisers Act requirement that "investment advisers" – generally all persons who are engaged in the business of providing advice regarding securities for compensation – register with the Securities and Exchange Commission. The private adviser exception exempts investment advisers with fewer than 15 clients that do not hold themselves out to the public as investment advisers or advise entities that are required to register with the SEC as investment companies. Most managers of private investment funds are able to take advantage of this exception because the funds they manage, rather than the investors in those funds, are considered to be their "clients" for purposes of the 15 client limitation and because those funds are usually exempt from registration as investment companies.

The House Bill would replace the "private adviser" exemption with four new exceptions to the Advisers Act registration requirement. The first would exempt advisers to "venture capital funds." That term is undefined in the House Bill – the SEC would be required to provide the definition and the specifics of the exemption by rulemaking. Nonetheless, it was almost certainly not the House committee's intent to extend the exemption to hedge funds. Even if the committee intended to also exclude managers of buyout and other types of private equity

funds from the exemption, we believe it may be difficult for the SEC to draft language that clearly exempts only managers of funds that are usually thought of by industry professionals as "venture capital funds." The SEC would have broad authority to require exempt advisers to maintain records and report to the SEC.

The second new exception would also require SEC rulemaking. The House Bill would direct the SEC to exempt from registration advisers to "private funds" that have assets under management in the U.S. of less than $150 million. A private fund for purposes of the House Bill is any entity that would be required to register with the SEC as an investment company but for certain exceptions to that requirement relied on by most private investment funds. We believe this exception, because it turns on the assets of the individual funds managed by the adviser rather than the adviser's total assets under management, is contrary to the goal of requiring the SEC registration of fund managers with significant assets under management and could result in implementation problems as managers structure their funds to take advantage of the exception. Again, the SEC would have broad authority to require reporting and record-keeping from advisers exempted by this exception.

The third new exception would be for advisers to small business investment companies ("SBICs"), which are generally funds that are licensed by, and receive financing from, the Small Business Administration under the Small Business Investment Act of 1958. This exception would apply to advisers who only advise SBICs (and, in certain cases, entities that have applied for or are in the process of obtaining an SBIC license). The requirement that the adviser "solely" manage SBICs may prohibit many SBIC managers from relying on this exception, as many of them also manage entities that are not licensed as SBICs.

The last new exception, for foreign private advisers, would apply to fund managers with no place of business in the U.S., with fewer than 15 clients in the U.S., and with less than $25 million in assets under management in the U.S., as long as they do not hold themselves out to the public in the U.S. as investment advisers or act as investment advisers to registered investment companies. The House Bill would permit the SEC to increase the $25 million limitation.

The House Bill would also require all registered fund managers to report to the SEC the amount of assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading and investment positions, and trading practices of the private funds they manage, and any other information with respect to those private funds that the SEC determines is necessary. The additional information required may be different for different types and sizes of funds, and the SEC would generally be required to consider the potential of various sizes and types of funds to contribute to systemic risk in prescribing the regulations implementing the legislation.

Although the House Bill provides that the SEC will not generally be compelled to disclose the information provided to it by private fund managers, there is no guarantee that such information will be kept confidential. The SEC would be required to share information with the Federal Reserve Board and other systemic risk regulators to the extent those regulators consider such sharing to be necessary for the regulation of systemic risk. The House Bill also gives the SEC new authority to require managers of private funds to provide any information it determines to be "necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk" directly to investors, prospective investors, counterparties, and creditors of the private funds they manage.

The enactment of the House Bill would likely result in two fundamental changes in the regulation of private fund managers as investment advisers. First, many managers of private funds would find that their exemption from registration would depend on the size of the funds, rather than the number of funds, that they manage. How far reaching that change is will depend on the SEC's definition of the term "venture capital fund", but the House Bill will almost certainly require the registration of nearly all managers of large hedge funds, which we believe is likely a key policy goal of the legislation. Just as important, the House Bill would delegate sweeping authority to the SEC to require fund managers to report to it, and perhaps even to fund investors and contractual counterparties, information regarding the private funds they manage.