# KEY U.S. HOUSE OF REPRESENTATIVES COMMITTEE HOLDS HEARING TO DISCUSS LEGISLATION THAT WOULD REQUIRE REGISTRATION FOR CERTAIN U.S. AND NON-U.S. PRIVATE FUND MANAGERS

At a hearing yesterday, the U.S. House of Representatives Committee on Financial Services convened to discuss legislative proposals that, if enacted, would require certain U.S. and non-U.S. managers of private funds to register as investment advisers with the Securities and Exchange Commission. The hearing focused on a draft bill published for discussion last week by Congressman Paul Kanjorski (D-PA),[1] which modifies earlier proposals by President Obama's administration and Senator Jack Reed (D-RI) relating to the regulation and oversight of private fund managers.[2] While Congressman Kanjorski's draft legislation generally is similar to those earlier proposals, it differs significantly in that it would not require registration under the Investment Advisers Act of 1940 for advisers to "venture capital funds." The draft legislation does not, however, define what constitutes a venture capital fund.

## *Proposed Registration Requirements*

Many U.S. and non-U.S. private fund managers currently rely on the "private adviser exemption" from registration under the Advisers Act, which allows a private fund manager to be exempt from registration as an investment adviser if, among other criteria, the manager advises fewer than 15 clients in a 12-month period.[3] Like the previous proposals, Congressman Kanjorski's draft legislation largely would eliminate the private adviser exemption. Subject to two exemptions discussed below, the legislation would require any person or entity that meets the definition of "investment adviser" under the Advisers Act and has more than $30 million under management to register as an investment adviser with the SEC under the Advisers Act—regardless of the number of clients the person or entity has.

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1 The text of the draft bill is available at: http://www.house.gov/apps/list/press/financialsvcs_dem/private_advisers_act_draft.pdf.

2 We provided overviews of the Obama administration's proposals and Senator Reed's legislation regarding private fund adviser registration in two previous client memos: *Implications of Proposed U.S. Financial Regulatory Reform for Non-U.S. Fund Managers* (July 31, 2009), *available at* http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3061/Implications%20of%20Proposed%20US%20Financial%20Regulatory%20Reform.pdf and *President Obama Announces Proposed New Oversight Requirements for Private Fund Managers* (June 18, 2009), *available at* http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2999/President_Obama_Announces_Proposed_New_Oversight_Requirements.pdf.

3 Advisers Act Section 203(b)(3). Section 203(b)(3) is not the exclusive means for a money manager to avoid registration as an investment adviser with the SEC. Non-U.S. private fund managers are required to count only U.S. clients toward the 14-client limitation.

The Kanjorski draft legislation and the Reed bill also would restrict the ability of private fund managers to rely on two other currently existing exemptions from registration: (1) the exemption for a private fund manager that is registered as a commodity trading advisor with the Commodity Futures Trading Commission and whose primary business does not involve acting as a securities investment adviser; and (2) the exemption for a private fund manager that does not provide advice regarding securities listed on a national exchange and whose clients are all residents of the same state in which the manager has its principal office and place of business.[4] These exemptions would continue to be available for a U.S. adviser that does not manage a "private fund," defined to include either a fund that is organized in the United States or a fund that is organized outside the United States and that has 10% or more of the value of its securities owned by U.S. persons.[5]

***Exemption for "Foreign Private Fund Advisers"***

Congressman Kanjorski's draft legislation and the Reed bill would provide an exemption from the registration requirement for "foreign private fund advisers." The Kanjorski bill defines "foreign private fund adviser" as a person or entity that:

- has no place of business in the United States; and
- during the preceding 12 months has had fewer than 15 clients in the United States and has had assets under management attributable to clients in the United States of less than $25 million (subject to increase by the SEC); and
- does not hold itself out generally to the public in the United States as an investment adviser or act as an investment adviser to a registered investment company.

Under this exemption, it appears that a non-U.S. private fund manager that manages one U.S. fund with $30 million or more in assets would be required to register as an investment adviser with the SEC.

Applying the current interpretation of the term "client," a non-U.S. private fund manager should not be required to count toward the $25 million threshold the assets of a fund it advises that is organized outside the United States, and would not need to look through the fund to its investors to determine whether assets were attributable to U.S. clients. The bill, however, would provide the SEC with authority to ascribe different meanings to the term "client" under the Advisers Act. At this time it is not clear whether the SEC would broaden the meaning of "client" to include

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[4] Advisers Act Sections 203(b)(1) (intrastate exemption) and 203(b)(6) (commodity trading advisor exemption).

[5] A U.S.-based adviser, therefore, that manages only non-U.S. funds that have 10% or less (by value) of their securities held by U.S. persons could continue to rely on these exemptions.

fund investors, but the SEC has attempted to do so in the past.[6] If the bill becomes law and the SEC uses the authority granted to it to revise the scope of the term "client" to include investors in a private fund, then a non-U.S. private fund manager would be required to count the assets of U.S. investors in a fund it manages toward the $25 million threshold. If a private fund manager's assets under management attributable to U.S. investors exceed $25 million, the manager would not qualify as a foreign private fund adviser and would have to register with the SEC. Such a result would be a significant expansion of the SEC's reach under the Advisers Act with respect to non-U.S. private fund managers.

***Venture Capital Fund Adviser Exemption***

Unlike previous proposals, Congressman Kanjorski's draft proposal requires the SEC to provide a new exemption from the registration requirement under the Advisers Act for managers of "venture capital funds." The draft legislation directs the SEC to define the term "venture capital fund" for purposes of the exemption; however, the intended scope of the definition is not clear from either the bill or the discussion during the hearing. Although the draft legislation would not require managers of venture capital funds to register under the Advisers Act, it would authorize the SEC to adopt a rule specifying records a venture capital fund adviser must maintain and mandate reports to be provided to the SEC.

***Next Steps***

This legislation signals Congress's ongoing focus on, and intention to pursue, increased regulation and oversight of private fund managers. As did the previous proposals by the Obama administration and Senator Reed, Congressman Kanjorski's draft legislation focuses on registration of advisers to private funds rather than registration of private funds under the Investment Company Act of 1940.[7] The legislation would subject managers of private funds—except for foreign private fund advisers and managers of venture capital funds—to Advisers Act requirements for registered investment advisers, including rules addressing advertising, custody of assets, recordkeeping and the implementation of compliance procedures and codes of ethics.

Based on our observations, it appears that registration and reporting requirements, whether in the form found in Congressman's Kanjorski's draft legislation or otherwise, are likely to be included as part of an overall financial regulatory reform package. The timing of enactment of legislation, however, remains unclear. We will continue to monitor and report on the proposals as they evolve.

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[6] In 2004, the SEC issued a rule that, among other things, defined "client" to include the investors in a private fund for purposes of determining whether the fund's adviser was eligible for the private adviser exemption. This interpretation of the term "client" was struck down by the U.S. District Court for the District of Columbia in 2006 as unreasonable and thus outside the SEC's authority. Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006). Congressman Kanjorski's bill would provide the SEC with the authority to define the term "client" to include investors in a private fund.

[7] In contrast, a bill introduced in January of this year by Senators Levin and Grassley would require registration of private funds under the Investment Company Act of 1940. Press Release, *Grassley and Levin Introduce Hedge Fund Transparency Bill*, http://levin.senate.gov/newsroom/release.cfm?id=307481 (Jan. 29, 2009).

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