ALERTS AND UPDATES

U.S. Senate Passes Massive Hedge Fund Managers Regulation Bill

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The U.S. Senate has passed the Private Fund Investment Advisers Registration Act of 2010 (the "Senate Bill"), which, if enacted in its present form, may have a dramatic impact on anyone who advises or manages a hedge fund or other investment-related pool of capital. In addition, when the Senate Bill is reconciled with a similar bill passed by the U.S. House of Representatives, the resulting legislation may also impact persons who advise small groups of clients, including so-called "family" accounts. Under the provisions of the Senate Bill, any private-fund advisor or manager with assets under management of at least $100 million would be required to register as an investment advisor with the U.S. Securities and Exchange Commission (the "SEC"). Advisors and managers with assets under management of less than $100 million, absent an available exemption, would be required to register as an investment advisor with one or more states.

The Senate Bill would trigger these registration requirements by eliminating the exemption for "small advisors" currently provided for in section 203(b)(3) of the Investment Advisers Act of 1940 (as amended, the "Investment Advisers Act"). That exemption is frequently relied upon by an individual or entity that might otherwise be classified as an "investment advisor" when it has had fewer than 15 domestic clients during the immediately preceding 12-month period and has not held itself out to the public as an investment advisor. Because most private investment funds are currently considered only one person – or client – advisors to such funds and pools can typically take advantage of the exemption. The Senate Bill would also eliminate the exemption from registration for an intrastate advisor that manages a private fund.

The Senate Bill contains certain exemptions from registration for "family offices" and for advisors to "private equity funds" and "venture capital funds." Under the Senate Bill, the SEC would be required to define these terms within six months after enactment. Other than these yet-to-be-defined exemptions, enactment of the Senate Bill would subject all other domestic investment advisors managing private pools of capital to registration with either the SEC or, unless exempted, one or more state regulatory agencies.

The Senate Bill, if enacted, would also require SEC registration of a foreign advisor, unless it is exempt from registration by satisfying the definition of a "foreign private advisor" because it: (1) has no place of business in the United States; (2) has fewer than 15 clients in total who are domiciled in or residents of the United States; (3) has aggregate assets under management attributable to U.S. clients and U.S. investors in "private funds" advised by it of less than $25 million (or such higher amount as the SEC may deem appropriate); and (4) neither (i) holds itself out generally to the U.S. public as an investment advisor, nor (ii) acts as an investment advisor to any investment company registered under the Investment Company Act of 1940 (as amended, the "Investment Company Act") or a business development company registered under the Investment Company Act.

Beyond the specific procedural, recordkeeping and reporting obligations that registration as an investment advisor will implicate, registration of currently nonregistered advisors and managers may also have a dramatic impact on fee structure and compensation. The Investment Advisers Act contains substantial limitations on performance-based fees, and advisors and managers who would be required to register for the first time may want to thoroughly review their fee structure to ensure compliance with applicable law.

Current registration requirements are imposed only on domestic hedge fund managers who do not qualify for the "small advisors" exemption and who have assets under management of at least $25 million. The Senate Bill would raise the current registration threshold from $25 million to $100 million, which would have the effect of requiring currently SEC-registered investment advisors with assets under management below $100 million to de-register with the SEC and comply with applicable requirements of one or more states.

Those required by the Senate Bill to register under the Investment Advisers Act would become subject to that Act's reporting, disclosure and recordkeeping obligations. Specifically, registered investment advisors are required to maintain records and file with the SEC disclosure reports regarding the amount of assets under management, the use of leverage including off-balance sheet leverage, counterparty credit risk exposure, trading and investment positions, trading practices, and any other information the SEC or the Federal Reserve deem necessary and appropriate. The SEC would be required to inspect the books and records of private funds maintained by an investment advisor, and provide an annual report to Congress describing how the SEC has used the data collected to monitor the markets for the protection of investors and the integrity of the markets.

The Senate Bill would modify Section 210(c) of the Investment Advisers Act by adding an additional exception to the rule that client information is confidential, which would enable the SEC to require the disclosure by SEC-registered investment advisors of client information "for purposes of assessment of potential systemic risk," as well as in connection with enforcement proceedings and investigations. However, in order to alleviate concerns of advisors and managers of the potential that registration and reporting of their proprietary trading and portfolio information could permit third parties to reverse-engineer or copy their investment strategies and methodologies, the Senate Bill would add a provision to the Freedom of Information Act that would exempt such information from the disclosure obligations of that law.

Finally, as relevant to fund advisors and managers, the Senate Bill would also allow the SEC in its discretion to promulgate rules to require advisors to take steps to safeguard client assets over which they have custody, including requiring verification by an independent public accountant.

Although not within the four corners of the Senate Bill, its legislative history suggests that, in addition to the increasing registration and operational requirements imposed on advisors, there would also be increased regulatory scrutiny of their activities and, likely, substantially increased enforcement action by the SEC and other regulators.

The Senate Bill would become effective one year after enactment, although an advisor would be permitted to register with the SEC at any time during the one-year transition period.

A conference committee is scheduled to convene this month to reconcile the differences between the Senate Bill and the version of the same name contained within the Wall Street Reform and Consumer Protection Act passed by the House in December 2009. The goal of the conference committee is to send a final bill to President Obama for his signature before Congress' July 4 recess.

Both the Senate and House versions vest a significant amount of discretion in the SEC regarding implementation, so the full impact of the legislation enacted will not be known for some time.

Financial reform legislation is a top priority for both Congress and the Obama administration, and the Senate Bill is the latest effort by Congress targeting the regulation of private investment funds, including hedge funds and private equity funds.

For Further Information

If you would like more information about this *Alert*, please contact Bob Bramnik, Loren Schechter, David Kaufman, Laurence Lese, Howell Reeves, any other member of the Broker-Dealer & Securities Regulation Practice Group, any member of the Corporate Practice Group or the attorney in the firm with whom you are regularly in contact.