IMPLICATIONS OF PROPOSED U.S. FINANCIAL REGULATORY REFORM FOR NON-U.S. FUND MANAGERS

Last month, the Obama administration submitted to Congress a legislative proposal, the Private Fund Investment Advisers Registration Act of 2009, which, if enacted, could affect registration requirements for non-U.S. fund managers who offer investment funds to U.S. persons.[1] Senator Jack Reed (D-RI) introduced similar legislation earlier this year.[2] If either proposal becomes law, some non-U.S. fund managers currently exempt from registration with the Securities and Exchange Commission under the Investment Advisers Act of 1940 ("Advisers Act") may be required to register as investment advisers. SEC registration would subject such non-U.S. fund managers to SEC oversight, as well as to a variety of substantive rules governing the conduct of the adviser's business.

Current exemption from registration. Many non-U.S. fund managers currently rely on the "private adviser exemption," which allows such managers to be exempt from registration if, among other criteria, they advise fewer than 15 clients in a 12-month period.[3] Currently, the term "client" is interpreted under the Advisers Act to include a fund advised by an investment adviser — not those persons who have invested in such a fund.[4] Non-U.S. fund managers are required to count only U.S. clients toward the 14-client limitation.

The Obama administration's proposed legislation. The Administration's proposal would entirely eliminate the private adviser exemption for U.S. money managers and would significantly limit it for "foreign private advisers," a newly introduced category of non-U.S. money managers. The proposal, would, among other things, require a person or entity that meets the definition of "investment adviser" under the Advisers Act and has more than $30 million in assets under management to register as an investment adviser with the SEC — regardless of the number of clients the adviser has. The proposal, however, provides an exemption from registration for a non-U.S. investment adviser that is a "foreign private adviser." A foreign private adviser would be any investment adviser that:

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[1] The text of the proposal is available at: http://www.ustreas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf.

[2] The text of Senator Reed's bill is available at: http://thomas.loc.gov/cgi-bin/query/z?c111:S.1276:.

[3] *See* Investment Advisers Act of 1940 § 203(b)(3), 15 U.S.C. § 80b-3(b)(3) (2006). Section 203(b)(3) is not the exclusive means for a non-U.S. money manager to avoid registration as an investment adviser with the SEC.

[4] *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) ("*Goldstein*"). Investors in a fund would be counted as clients, however, if the investment adviser provides advice to them individually and not to the fund as a whole. This memorandum assumes advice is provided only to the fund.

- has no place of business in the United States;[5]
- during the preceding 12 months has had fewer than 15 clients ***and*** has had assets under management attributable to clients in the United States of less than $25 million (subject to increase by the SEC);
- does not hold itself out generally to the public in the United States as an investment adviser; and
- does not act as an investment adviser to a registered investment company.

Applying the current interpretation of the term "client," a non-U.S. money 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 proposal, 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 fund investors, but the SEC has attempted to do so in the past.[6] If the proposal 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 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.

The Administration's proposal would also eliminate from the Advisers Act the exemption from registration currently available to a non-U.S. fund manager that is registered as a commodity trading advisor ("CTA") with the Commodity Futures Trading Commission and whose primary business does not involve acting as a securities investment adviser. The proposal would specifically eliminate the registered CTA exemption if the CTA provided advice to a "private

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[5] The term "place of business" is not defined in the legislative proposal. In a separate rule that was vacated following the *Goldstein* decision, however, the SEC defined "place of business" as (i) an office at which the investment adviser representative regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (ii) any other location that is held out to the general public as a location at which the investment adviser representative provides investment advisory services, solicits, meets with, or otherwise communicates with clients. It is unclear, at this point, whether the intent is to carry this definition or a similar one forward. *See* Investment Advisers Act Rule 203A-3.

[6] In 2004, the SEC issued a rule which, 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. *See Goldstein*, *supra*. The President's proposal and the Reed bill both provide the SEC with the authority to define the term "client" to include investors in a private fund.

fund." The proposal defines the term "private fund" as an entity that would be an investment company as defined in the Investment Company Act of 1940 ("1940 Act") except for the exclusions from that definition provided in Sections 3(c)(1) or 3(c)(7) of the 1940 Act, and that either (i) is organized under the laws of the United States, or (ii) has 10% or more of its outstanding securities owned by U.S. persons. Non-U.S. managers seeking to continue to rely on this exemption would need to closely monitor the level of investment by U.S. persons, even if the manager's fund is small in size or would be considered a start-up. Senator Reed's bill would not eliminate the registered CTA exemption.

New obligations of investment advisers to private funds. The President's proposal would not require private funds to register as investment companies, but would use the investment adviser's registration to increase the reporting provisions applicable to private funds under the Advisers Act. The SEC would be granted the authority, under the Advisers Act, to require investment advisers to maintain records and reports regarding the private funds they advise and make these reports and records available, upon request, to the SEC, the Board of Governors of the U.S. Federal Reserve System and the proposed Financial Services Oversight Council.[7] The proposed legislation requires, at a minimum, that the investment adviser of a private fund maintain records and reports that include information regarding assets under management, use of leverage (including off balance sheet leverage), counterparty credit risk exposure, trading practices and trading and investment positions. In addition to these minimum requirements, the SEC, in consultation with the Federal Reserve Board, would be authorized to compel an investment adviser of a private fund to submit any other information that the SEC deemed necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. The records the registered investment adviser would have to maintain would be subject to periodic, special or other examination by the SEC. The proposed legislation also would authorize the SEC to require a registered investment adviser to disclose the identity of its investors.[8] The proposal does not address the situation in which an adviser is not the sponsor of, or otherwise establishes, the fund. We note that if the adviser does not control the fund, it possibly may not have access to information that it would be required to provide to the SEC.

The proposed legislation would state that the SEC could not be compelled to disclose any information it received pursuant to the contemplated requirements. That might provide some protection for confidential information. The proposed legislation, however, would not authorize the SEC to withhold information from Congress, any federal agency or department, self-

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[7] The Financial Services Oversight Council was proposed in the President's U.S. financial services regulatory reform plan, which was released on June 17, 2009. The proposed plan is discussed in our earlier Client Memorandum entitled, "President Obama Announces Proposed New Oversight Requirements for Private Fund Managers," available at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2999/President_Obama_Announces_Proposed_New_Oversight_Requirements.pdf.

[8] The legislative proposal calls for the removal of Section 210(c) of the Advisers Act, which prohibits the SEC from compelling an investment adviser to disclose the identity of its clients, unless such disclosure is necessary or appropriate in a particular enforcement proceeding or investigation.

regulatory organization or federal court. The broad powers the proposal would grant to the SEC would allow the SEC to create rules or regulations requiring a registered investment adviser to provide such reports, records and other documents to investors, prospective investors, counterparties and creditors of any private fund advised by the investment adviser.

It currently appears that the Obama administration's proposal or a combination of that proposal and Senator Reed's bill will likely be enacted, although the timing of any resulting registration requirement remains unclear. We will monitor the proposals as they relate to non-U.S. fund managers and expect to issue further alerts as significant developments occur.

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July 31, 2009