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Client Alert

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New House Bill Would Require Registration of Almost All Investment Advisers

Many advisers to hedge funds, private equity funds, venture capital funds and fund of funds use the "private adviser exemption" to avoid having to register with the SEC as investment advisers, if they have fewer than 15 clients in any 12 month period. A bill, introduced in the House of Representatives on January 27, 2009, would repeal this exemption. If this bill is adopted, then any advisers previously relying on this exemption would be required to register with the SEC.

The Hedge Fund Adviser Registration Act of 2009 (the "Bill")[1] was introduced by Representatives Michael Capuano and Michael Castle. The Bill proposes to eliminate Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Advisers Act"). Section 203(b)(3) exempts advisers who have a limited number of clients (private investment funds are generally deemed to be the clients advised by the advisers), and who do not hold themselves out to the public as investment advisers, from the registration requirements of the Advisers Act and most of its rules.

This Bill was introduced at approximately the same time as the Hedge Fund Transparency Act of 2009 was submitted in the Senate by Senators Chuck Grassley (R-Iowa) and Carl Levin (D-Mich).[2]

Current Rules

The most common exemption from registration relied on by advisers to hedge funds, private equity funds, venture funds and fund-of-funds is the private adviser exemption. The private adviser exemption is available to any adviser that:

- has advised fewer than 15 clients in the course of the preceding 12 months; and
- does not hold itself out generally to the public as an investment adviser.

When counting clients for the private adviser exemption, the Advisers Act permits (i) any adviser to generally count a pooled vehicle as a single client and (ii) a non-U.S. adviser to count only those clients that are U.S. residents.

The Bill Would Eliminate the Private Adviser Exemption

If the Bill is enacted in its current form, the private adviser exemption would be repealed and all investment advisers with U.S. clients would be required to register with the SEC. To be clear, this Bill would require not only advisers to hedge funds to register with the SEC, but also advisers to other types of pooled investment vehicles such as venture capital funds, private equity funds and CDOs.

The Bill should also be of concern to non-U.S. advisers. Currently, a non-U.S. adviser may advise an unlimited number of non-U.S. clients and up to 14 U.S. clients without needing to register. Such non-U.S.

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[1] The text of the Bill is available at http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.711.IH:.

[2] For a discussion of this Bill see our Client Alert dated February 3, 2009 at http://www.proskauer.com/news_publications/client_alerts/content/2009_02_03.

clients often include non-U.S. private funds which may have U.S. investors. The Bill would require any non-U.S. adviser who has even a single U.S. client to register.

The Bill would not, however, appear to repeal the *Goldstein* case, or otherwise change the manner in which an adviser determines the identity of its "clients" for any purpose under the Advisers Act. Therefore, we would expect that a non-U.S. adviser would not have to register with the SEC if it only advises non-U.S. funds even if their non-U.S. funds have U.S. investors.

What Registration Means

Advisers that are not presently subject to registration should be aware that the following requirements of registration could substantially impact their business:

- *Fees/Carried Interest* – Subject to certain exceptions, including an exemption for investors having a net worth of at least $1.5 million, Section 205(a)(1) of the Advisers Act generally prohibits an investment adviser from entering into any advisory contract with an investor that provides for compensation based on a share of gains. This prohibition includes fund agreements that provide for carried interest. The Bill does not provide for transitional relief or grandfather existing arrangements.

- *Form ADV* – An adviser required to register must file a Form ADV. There are two parts to the Form ADV. Part I provides information regarding the adviser, its officers and directors and the size of its business. Part II requires disclosure of the business practices of the adviser. Each registered investment adviser is required to provide its clients with a copy of its Part II or an equivalent disclosure document prior to engaging in an advisory relationship and, subsequently, to annually deliver, or offer to deliver, without charge, a copy of Part II upon written request.

- *Inspections* – As part of its oversight of investment advisers, the SEC regularly inspects advisers to confirm they are in compliance with the Advisers Act and other applicable federal securities laws, and that the adviser's business activities are consistent with the information disclosed in its Form ADV.

- *Advisory Contracts* – The Advisers Act imposes certain requirements on investment advisory contracts, including requiring that such agreements not be assigned by the adviser without the client's consent.

- *Custody* – Generally, an investment adviser having custody of client assets must maintain such assets with a "qualified custodian." Qualified custodians include banks and broker-dealers.

- *Recordkeeping* – The Advisers Act imposes extensive recordkeeping requirements on registered advisers. Such records include typical business accounting records, and certain additional records in light of the special fiduciary nature of the investment advisory business.

- *Compliance Program* – Registered investment advisers are required to maintain and enforce a written code of ethics, which must include a requirement that "access persons" of the investment adviser pre-clear purchases of IPOs and private placements and report all personal securities transactions periodically to the adviser, and standards employees must adhere to in order to comply with applicable securities laws. Registered advisers are also required to adopt allocation compliance procedures and appoint a compliance officer.

New Connecticut Hedge Fund and Private Equity Fund Proposals

Connecticut may begin regulating private funds in a more aggressive manner. State lawmakers have introduced three bills (each described below) which would significantly increase oversight of hedge and private equity funds which have some presence in Connecticut. **Although the proposals generally use the term "hedge fund" they would also apply to private equity and other funds.**

Bill No. 6480

Bill No. 6480 would require Connecticut domiciled funds to disclose to Connecticut pension plan investors detailed portfolio information upon request.

Bill No. 953

Bill No. 953 includes the following provisions:

- Starting in 2011, covered funds would not be permitted to have individual investors who do not have at least $2.5 million in "investment assets";

- Starting in 2011, covered funds would not be permitted to have institutional investors who do not have at least $5 million in "investment assets";

- Funds will be required to disclose the existence of side letters; and
- An annual audit would be required beginning in 2010.

The above provisions would apply to those funds which have an office in Connecticut where employees "regularly conduct business" on behalf of the fund. It is not clear that there would be any sort of grandfathering for funds which have investors who do not meet the investment assets threshold.

Bill No. 6477

This bill would require funds to purchase a $500 license prior to conducting business in Connecticut. The license would need to be purchased every year and the bill also provides the Banking Commission with authority to adopt regulations for licensing.

Recent Proposed Changes to Taxation of Carried Interest

The taxation of carried interest has been under intense legislative scrutiny in recent years. In the summer of 2007, Representative Levin introduced a bill to effectively tax carried interest as compensation income. Although that bill was broad in nature (leaving opportunities for tax planning), many of those opportunities were addressed when Representative Rangel introduced similar, more detailed, legislation in the fall of 2007. Neither bill was enacted into law, and there is currently no proposed legislation on this issue. President Obama, however, included a provision in his budget today that would tax carried interest as compensation income. We are expecting to receive more detail on that provision with the issuance of the President's detailed budget at the end of March. The budget is generally expected to act as a blueprint for congressional legislators. The President's budget also calls for zero capital gains taxation for small businesses.

Until there is more insight into the specific provisions of any legislation on this issue, we believe that taking any action now to depart from existing fund structures in anticipation of a proposed change in the tax laws applicable to carried interest is premature.

We will be monitoring actively all these tax and regulatory proposals. As always, please contact any of the lawyers listed below with any questions.

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Proskauer's Private Investment Funds Group comprises more than 100 lawyers and advises clients worldwide on all of the legal and business issues important to private equity and hedge funds and their managers, including structuring investment vehicles of all types, portfolio company investments, institutional investor representation and secondary purchases and sales.

Please feel free to call any of the Proskauer lawyers listed below at any time if you have additional questions, or if we can be of additional assistance with the issues raised in this note.

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