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Private Equity and Hedge Fund Advisers Will Be Required to Register with the SEC Under House-Senate Compromise Legislation

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On Friday, a House and Senate conference committee agreed to require the vast majority of private equity and hedge fund advisers to register with the SEC under the Investment Advisers Act. Venture capital fund advisers are specifically excluded from registration. Both houses of Congress now need to approve the legislation before it can be signed into law by the President. Below is a summary of the conference committee proposal. Importantly, there is a one-year transition period built into the legislation. Accordingly, private equity and hedge fund advisers would not be required to register with the SEC until at least July 2011.

Venture Fund Advisers

The proposed bill requires registration with the SEC under the Investment Advisers Act for advisers to hedge funds and private equity funds, but includes an exemption from registration for advisers to venture capital funds. The venture capital exemption only applies to a manager that acts as an adviser “solely” to one or more venture capital funds. The exemption requires the SEC to define the term “venture capital fund" within one year from the date of enactment. It is not clear from the legislation whether venture capital funds of funds will be covered by the exemption.

Family Offices

The bill provides a lengthy exemption for family offices. The bill would require the SEC to adopt a definition of "family office" that is "consistent" with previous exemptive orders and "recognizes the range of organizational, management, and employment structures and arrangements employed by family offices."

Non-U.S. Advisers

The compromise proposal includes a new (but very limited) exemption from registration for "foreign private advisers." Many non-U.S. managers will not satisfy the requirements of the exemption. In order to qualify for this exemption, a non-U.S. adviser must (i) have no place of business in the United States, (ii) have fewer than 15 U.S. clients and investors in private funds advised by the investment adviser, (iii) have less than $25,000,000 attributable to U.S. clients and investors, and (iv) not hold itself out as an investment adviser in the United States. Because of the way this provision is written, a foreign adviser that manages $25,000,000 or more in U.S. investor money in its private funds (whether organized in an onshore or offshore jurisdiction) would not be able to use this exemption to avoid registration.

However, as described in the next paragraph, there is a new general exemption from registration if the manager “has assets under management in the United States of less than $150,000,000.” It is not clear how this language relates to the foreign private adviser provisions described above, and in particular whether a non-U.S. manager can avoid registration if it does not have any U.S. clients (i.e., does not manage any fund vehicles formed in the United States or any managed accounts for U.S. clients) and only manages non-U.S. private funds with less than $150,000,000 in U.S. assets. It is unclear how the SEC will interpret this language.

Other New Exemptions From Registration

With respect to private fund managers, the bill adds a new exemption from registration if the manager has less than $150,000,000 in U.S. assets under management and the manager acts “solely” as an adviser to private funds.

In addition, with respect to managers that do not act “solely” as an adviser to private funds (for example, a hedge fund manager with both managed accounts and private funds) and have less than $100,000,000 under management, such managers would not be required to register with the SEC unless (i) the adviser would be required to register with 15 or more states or (ii) the adviser would not be required to register with the state in which it maintains its principal office and place of business (and be subject to state examinations).

Currently, advisers registered at the federal level are not required to register with state securities regulators. Due to the new SEC registration thresholds, some managers with less than $150,000,000 in assets under management may be required to de-register with the SEC and become subject to registration in multiple states.

New Reporting Requirements

The bill provides that the SEC must issue rules requiring each adviser (venture capital firms are not exempt) to a private fund to file reports with the SEC that the SEC deems necessary or appropriate for protection of investors and assessment of systemic risk.

Restricted Bank Involvement with Proprietary Trading, Hedge Funds and Private Equity Funds

The bill provides a general prohibition, subject to several exceptions, on any banking entity engaging in proprietary trading or acquiring any ownership interest in, or sponsoring, any hedge fund or private equity fund. Among the exceptions, the sponsorship by a banking entity of hedge funds and private equity funds is permitted, provided that the banking entity complies with certain rules. These rules include making only a "*de minimis*" investment in any such fund (or having such investment diluted to such level within one year of the fund's establishment), defined as not more than 3% of the total ownership interests of any such fund, provided that (i) the total of all fund interests held by the banking entity are not more than 3% of the Tier 1 capital of such banking entity and (ii) such investment is "immaterial" to the banking entity, as defined by the regulators pursuant to rulemaking. Certain types of proprietary trading also continue to be permitted, including genuine hedging activities, the purchase and sale of certain U.S. government and government-backed securities, and continued proprietary trading by non-U.S. banks outside the United States.

Changes to Accredited Investor and Qualified Client Standards

The bill provides that the value of an investor's primary residence will now be excluded from such investor's "net worth" in determining whether such investor is an "accredited investor."

The bill also requires that the SEC periodically adjust the accredited investor standard, as necessary for the protection of investors, the public interest and in light of the economy. Similarly, the bill will require the SEC to periodically adjust the “qualified client” thresholds to adjust for the effects of inflation.

Special Assessment Imposed

The bill also provides for a new tax on certain “financial companies” to pay for the costs of its implementation, including financial companies “that manage hedge funds” with at least $10 billion in assets under management. The term “hedge fund” is to be defined by the Financial Stability Oversight Council in consultation with the SEC, and companies that manage hedge funds with less than $10 billion under management are exempt from the new assessment. The “Financial Crisis Special Assessment” is expected to generate at least $19 billion in revenue between 2012 and 2015, and will be assessed using thirteen broad “risk-based” criteria, including the extent of a financial company’s leverage, its importance as a source of credit, and the degree to which the assets of the financial company are managed, rather than owned by the company.

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