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KIRKLAND **BRIEF**

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U.S. Regulation Update: Investment Advisers Act Registration for Private Fund Managers

As part of an overall financial services regulatory reform package, U.S. federal regulation of private investment fund managers is likely. Those private equity firms with U.S. operations, or with commitments from U.S. investors, should begin to prepare for registration under the IAA.

The US Investment Advisers Act of 1940 (the "IAA") regulates the activities of persons who, for compensation, advise others about investing in, purchasing or selling securities, and requires them to register with the US Securities and Exchange Commission ("SEC") or have an exemption from registration. In addition, almost all US states regulate those non-SEC registered investment advisers with a place of business in the state.[1]

Currently, many private equity fund managers rely on an exemption from registration under the IAA. However, it is likely that there will soon be U.S. federal regulation of private investment fund managers as part of an overall financial services regulatory reform package, so those private equity firms with U.S. operations, or with significant commitments from U.S. investors, should begin to prepare for registration under the IAA.

Although the detailed regulatory requirements of the two regimes differ, many aspects of SEC regulation will be familiar to firms currently authorised and regulated by the UK Financial Services Authority ("FSA").

The three requirements that are likely to have the most practical impact for such firms are:

- Preparation of U.S. GAAP audited financials (or reconciliation to U.S. GAAP) as the least burdensome means of complying with the IAA custody rule;
- Detailed requirements relating to the presentation of track record information in private placement memorandums and other marketing documents; and
- Potential reporting to the SEC of information regarding "private funds" (as defined below). Current Exemptions

Current Exemptions

Many private equity fund managers are currently exempt from registration under the IAA on the basis that they have fewer than 15 clients in any 12-month period (generally counting each fund vehicle as one client and, for non-U.S. managers, counting only US clients). To benefit from the exemption, a firm must not be held out publicly as an investment adviser.[2]

Proposed Legislation

The Private Fund Investment Advisers Registration Act of 2009 and similar US legislative proposals would eliminate the fewer-than-15-client exemption for investment advisers, including managers of private investment funds, who have assets under management ("AUM") of US$30 million or more.[3]

There is a limited exemption for non-US fund managers, which applies if:

- the fund manager does not have a place of business in the US; and
- the fund manager has fewer than 15 clients in the US in any 12-month period; and
- less than US$25 million AUM is attributable to clients in the US; and
- the fund manager is not held out in the US as an investment adviser.[4]

The Private Fund Investment Advisers Registration Act would require an investment adviser to report to the SEC certain information regarding any "private fund" it advises. The proposed legislation defines "private fund" as any fund relying on section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940,[5] which fund is organised under US law (e.g. a Delaware limited partnership) or is a fund in which 10% or more of the limited partnership interests are held by US persons. The information required to be reported to the SEC under the proposed legislation would include assets under management, use of leverage, counterparty credit risk exposures, trading and investment positions, and trading practices.

SEC Registration

The SEC registration process is broadly similar to an application for FSA authorisation. The firm is required to provide detailed information to the SEC about the firm and its business, through an online form, Form ADV. The firm must also prepare a Form ADV, Part II disclosure document for investors containing information about matters such as investment techniques, investment team biographies, management fees and performance fees or carried interest, conflicts of interest and, in some cases, audited financials. Form ADV must be updated annually, or in the event of material changes.

Once registered, a firm will be subject to conduct of business regulation covering, among other things:

- Appointment of a compliance officer, and maintenance of a compliance programme
- Proxy voting
- Custody requirements for cash and securities
- US GAAP audited financials (the approach generally taken by private equity fund managers to satisfy the IAA custody rule)
- Valuation
- "Pay to play" restrictions on political contributions and placement agent fees, and disclosure of placement agent fees relating to solicitation of US state and municipal plans[6]
- Advertising restrictions, particularly in relation to presentation of track record information
- Restrictions on changes of control of the private equity firm without investor consent
- Restrictions on carried interest (although 3(c)(7) funds and many 3(c)(1) funds are exempt from these restrictions),

plus other matters that will be familiar to FSA authorised firms, such as financial promotions, conflicts of interest, personal account dealing, insider trading, anti-money laundering, disaster recovery, gifts, best execution, soft commissions, books and records and data protection/investor privacy.

The firm will also be subject to periodic inspections by the SEC, and may receive occasional unannounced inspections.

1 SEC registration as an investment adviser preempts state registration.

2 In addition, a firm must not advise a SEC-registered investment company or business development company ("BDC") within the meaning of the Investment Company Act of 1940.

3 There are other US legislative proposals, but the Private Fund Investment Advisers Registration Act of 2009 is currently considered the most likely to reflect the expected scope of regulation.

4 In addition, the fund manager must not advise a SEC-registered investment company or BDC.

5 The IAA was enacted together with the US Investment Company Act of 1940 (the "ICA"), which regulates entities whose primary business is investing in securities of other companies (e.g., private funds). Private equity funds generally rely on one of two exemptions under the ICA. The most commonly used exemption is contained in section 3(c)(7) of the ICA, which exempts funds privately offered if all investors are qualified purchasers ("QPs") or for non-US funds, all US investors are QPs. A QP generally means an individual who owns at least US$5m in investments or a company that owns at least US$25m in investments. The other relevant exemption is contained in section 3(c)(1) of the ICA, which exempts funds privately offered if there are no more than 100 limited partners or beneficial owners as determined under the ICA or, for non-US funds, no more than 100 US limited partners or beneficial owners. To rely on either of these exceptions, a fund must not make a public offering of its securities.

6 The SEC has proposed a rule which has not yet been adopted.

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