TRAVERS SMITH

Investment Funds

US developments that affect non-US managers

On both sides of the Atlantic, the investment funds industry is being subjected to greater scrutiny and regulation. In Europe, the draft AIFM Directive is still the cause of much debate, while in the United States the long-awaited overhaul of the financial markets has now become law with implications for the wider funds industry (including for non-US managers). These new laws and other US developments are described below.

The Registration Act

On 21 July 2010, the Private Fund Investment Advisers Registration Act was passed into law by President Obama. This forms part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Non-US managers of private funds which are offered in the US must now register with the SEC as "investment advisers" unless they fall within an exemption. This will apply, even if the non-US manager is regulated in its home country. For the purposes of the legislation, the term private funds covers a wide array of fund structures and asset classes, including investment vehicles set up for private equity, hedge, real estate, debt and infrastructure and funds of funds. However, generally you ignore public offerings to non-US persons outside the US.

The exemptions which are likely to be relevant for non-US managers are:

(i) a manager of a private fund (whether US or non-US) with less than $150 million of assets under management in the US will be exempt from registration. The key will be determining the meaning of the phrase "assets under management in the US"; this has been left to the SEC to finalise at a later date. It is hoped that the phrase will refer to the assets of the fund rather than the commitments of US investors;

(ii) managers who act solely for venture capital funds will also be exempt from registration. It has been left for the SEC to determine how broadly defined the term "venture capital fund" will be for this purpose; and

(iii) there is a general "foreign private advisers" exemption, which applies to non-US managers with fewer than 15 US investors and less than $25 million in assets under management attributable to US investors. Because of the low threshold, it is anticipated that this exemption will be of limited use.

For any manager relying on the first or second exemptions, there will still be record-keeping and reporting requirements imposed by the SEC. Again, the precise scope of these obligations and the extent to which they will apply to non-US managers is still unclear.

There is a 12-month transition period, so any required SEC registration will not need to be implemented until 21 July 2011.

Carried interest changes

The House of Representatives in the US has now passed the American Jobs and Closing Tax Loopholes Act which intends to subject carried interest to US federal income tax. The legislation needs to be approved by the Senate before it is finally signed into law. The House of Representatives version of the legislation would initially see 50% of carried interest allocated to an individual being subject to federal income tax, although this figure would rise to 75% over a number of years. The Senate is discussing a variety of different proposals, with the level of federal income tax for carried interest being adjusted over different periods of time. Despite some fierce lobbying from the private equity industry, the current proposals in the Senate seem likely to result in at least 50% of an individual's carry in each tax year being subject to federal income tax.

Some form of legislation in the US on carried interest now seems inevitable, but the exact level of taxation obviously still needs to be settled. It's also worth noting that these proposals will only affect individuals who are subject to US federal income tax, so the proposals are unlikely to have a direct impact on the vast majority of non-US managers. However, the concern is the extent to which these proposals influence policy in other jurisdictions, such as the UK.

The Volcker Rule

As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the US has enacted the Volcker Rule aimed at restricting the size and scope of risk-taking activities of banking institutions. As adopted, this rule prohibits any "banking entity" regulated by the Federal Reserve Board in the US from investing in or sponsoring hedge funds and private equity funds. In this context, 'sponsoring' a fund means serving as the general partner/managing member or controlling a majority of the directors.

The legislation refers to hedge funds and private equity funds but the definitions are potentially much broader than these two asset classes. It is hoped that the regulators will implement rules to avoid prohibiting structures that were not intended to be covered, but it is considered likely that investment vehicles set up for private equity, hedge, real estate, debt or infrastructure and funds of funds will still be caught.

The general prohibition on US banking entities investing in hedge funds or private equity funds will affect non-US funds as well as US funds and will reduce the amount of available investor capital to investment funds. There are a number of exceptions to the general prohibition that may allow a US banking entity to invest in certain funds or even to operate a fund of funds business or hold an indirect non-controlling interest in a company that is itself the manager of an investment fund. However, the exceptions will be subject to restrictions (such as the banking entity not acquiring more than a *de minimis* investment of 3% of less of the fund's total interests) and, to make use of them, it is likely that an element of reorganising or restructuring will be needed. As a result, we would anticipate that US banking entities will need to reduce their exposure to private equity and hedge funds, both in terms of operating captive funds and investing into third party funds. This will have an obvious knock-on impact for non-US funds and non-US managers.

How to find out more

In many cases, how these regulatory changes in the US will affect non-US managers will depend on the rules and guidance that are introduced to implement the legislation. Similarly, the impact on carried interest in the US will depend on the final form of the proposals. We will be monitoring each of these situations carefully. In the meantime, if you require any further information about the matters referred to above then please feel free to contact us.

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