HUNTON& WILLIAMS

PRIVATE INVESTMENT FUND UPDATE

July 2009

Obama Administration Proposes Registration and Additional Reforms Impacting Private Fund Advisers

On July 10, 2009 and July 15, 2009, the Obama administration proposed the "Private Fund Investment Advisers Registration Act of 2009" (the "Registration Proposal") and the "Investor Protection Act of 2009" (the "Investor Protection Proposal") to implement a portion of the proposals included in the Obama administration's White Paper on Financial Regulatory Reform, released on June 17, 2009. The Registration Proposal and the Investor Protection Proposal could have a significant impact on advisers to private funds, such as hedge funds, private equity funds and permanent capital vehicles, by (1) requiring the registration of unregistered advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and (2) revising the standards of conduct applicable to all investment advisers, including those that have already registered.

The Registration Proposal

The Registration Proposal includes the following proposals:

- **Elimination of Private Adviser Exemption**: The Registration Proposal eliminates the private adviser exemption found in Section 203(b)(3) of the Advisers Act (also known as the "15 client" exemption). Many investment advisers to private funds rely on the private adviser exemption as well as the client counting rules found in Rule 203(b)(3)-1 to avoid registration under the Advisers Act. The elimination of the private adviser exemption would require all investment advisers with $30 million in assets under management to register with the SEC. Investment advisers with less than $25 million in assets under management are prohibited from registering under the Advisers Act and are subject to state registration. Although general partners and managers to private funds are already subject to the antifraud rules of the Advisers Act, if they are required to register as investment advisers, they will become subject to all provisions of the Advisers Act, including its rules relating to client asset custody, recordkeeping, advisory contracts, performance fees, ethics and personal trading policies, investment and financial reporting, and advertising.
- **New Definition of "Private Fund"**: The Registration Proposal creates a new definition of "private fund" under the Advisers Act. Under the new definition, a "private fund" includes an investment fund that:
  - relies on the exemption from investment company status found in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act"); and
  - either is organized under the laws of the United States or any state or has 10 percent or more of its outstanding securities owned by U.S. persons.
- **Limited Exemption for "Foreign Private Advisers"**: The Registration Proposal adds a new limited exemption from registration under the Advisers Act for investment advisers that are "foreign private advisers." A "foreign private adviser" includes any investment adviser that:
  - has no place of business in the United States;
  - during the preceding 12 months has had fewer than 15 clients in the United States and assets under management attributed to clients in the United States of less than $25,000,000; and
  - neither holds itself out generally to the public in the United States

as an investment adviser nor acts as an investment adviser to a registered investment company or business development company.

- **Contraction of Intrastate Exemption**: The existing intrastate exemption found in Advisers Act Section 203(b)(1) for investment advisers whose clients are all residents of the state in which the investment adviser maintains its principal place of business remains in place. But the Registration Proposal amends the intrastate exemption to exclude from its coverage investment advisers to "private funds."

- **Contraction of Exemption for Commodity Trading Advisers**: The Registration Proposal also limits the exemption found in Advisers Act Section 203(b)(6) for commodity trading advisers whose business does not consist primarily of acting as an investment adviser to exclude investment advisers to "private funds."

- **Information Gathering**: The Registration Proposal adds a new provision authorizing the SEC to require registered investment advisers to private funds to submit reports regarding the private funds they advise for the assessment of systemic risk by the Federal Reserve and the Financial Services Oversight Council ("FSOC"). The required records and reports include for each private fund:

  - the amount of assets under management,
  - use of leverage (including off-balance sheet leverage),
  - counterparty credit risk exposures,
  - trading and investment positions,
  - trading practices, and
  - such other information as the SEC in consultation with the Federal Reserve determines necessary or appropriate in the public interest and for the protection of investors for the assessment of systemic risk.

  In addition to new recordkeeping and examination provisions relating to the records of private funds, the Registration Proposal requires the SEC to share reports, documents, records and information with the Federal Reserve and the FSOC for the purposes of assessing the systemic risk of a private fund or assessing whether a private fund should be designated a Tier 1 financial holding company.

- **Information Sharing**: Although the Registration Proposal indicates that the reports, documents, records and information obtained by the Federal Reserve and the FSOC shall be kept "confidential," the proposal also provides that the SEC may not withhold information from Congress and may comply with requests for information from other agencies. Many funds may regard information of the type sought by the proposal as sensitive competitive information. The lack of significant confidentiality protections in the proposal for this information may present a new business dynamic for private funds.

- **Client-Related Disclosures**: The Registration Proposal deletes in its entirety Section 210(c) of the Advisers Act, which provides that an investment adviser shall not be required by the Advisers Act to disclose the identity, investments or affairs of any of the adviser's clients except as may be necessary in a particular proceeding or investigation to enforce the provisions of the Advisers Act.

- **Rulemaking Authority**: The Registration Proposal amends Advisers Act Section 211 to expand the SEC's rulemaking authority so that it may ascribe different meanings to terms used in different sections of the Advisers Act as the SEC determines is necessary. This would permit the SEC the flexibility to interpret terms such as "client" in different ways, a discretion that was denied the SEC in the *Goldstein v. SEC* case.[1] The Registration Proposal also requires the SEC and the Commodity Futures Trading Commission ("CFTC") to consult with the Federal Reserve and jointly promulgate rules regarding reports required to be filed with the SEC and the CFTC by investment advisers that are registered under both the Advisers Act and the Commodity Exchange Act.

A copy of the Registration Proposal is available here.

The Investor Protection Proposal

The Investor Protection Proposal includes the following proposals:

[1] *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

- **Fiduciary Duty Standard for Brokers, Dealers and Investment Advisers**: The proposed legislation amends Section 15 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and Section 211 of the Advisers Act to provide that the SEC may promulgate rules to provide, in substance, that the standards of conduct for all brokers, dealers and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the SEC may by rule provide), shall be "to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice." Currently, brokers are subject only to a "suitability" standard under the Exchange Act, while investment advisers are subject to a higher "fiduciary" standard based on the antifraud rules and common law to act in their client's best interests and to make full and fair disclosure of material facts. The new fiduciary standard outlined in the proposal is similar to the ERISA standard of care, which is generally considered to be a higher standard than the fiduciary standard applied to investment advisers generally. While it is unclear whether the standard described in the proposed legislation would be applied to sophisticated investors in private investment funds in addition to the specified "retail customers," if such a standard were to apply, it would prohibit any transactions that are not solely in the interest of the private investment fund. Unless further clarification is provided, it appears that transactions in which an investment adviser balances the conflicting interests of multiple clients as disclosed in fund documents, such as those involving allocations of portfolio investments among several existing funds, may require rethinking.

- **Disclosures, Conflicts, Compensation and Other Practices**: The Investor Protection Proposal also amends the Exchange Act and the Advisers Act to provide that the SEC shall take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals, including consultation with other financial regulators on best practices for consumer disclosures. In addition, the proposed legislation requires the SEC to examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest and compensation schemes for financial intermediaries (including brokers, dealers and investment advisers) that it deems contrary to the public interest and the interests of investors.

- **Timing of Investor Disclosures**: The proposed legislation amends Section 24 of the Investment Company Act to provide that the SEC may promulgate rules designating documents or information that must precede a sale of securities issued by a registered investment company. At this point, it is unclear what documents or information would be required to be delivered.

- **Whistleblower Incentives**: The Investor Protection Proposal adds a new Section 21F to the Exchange Act, providing for a reward of 30% of the total monetary sanctions for whistleblowers in SEC actions under the securities laws that result in monetary sanctions exceeding $1 million. The proposed legislation not only facilitates the SEC's use of rewards, but also permits their use in a broader range of SEC enforcement actions.

- **Aiding and Abetting Liability**: The Investor Protection Proposal amends Section 15 of the Securities Act, Section 48 of the Investment Company Act and Section 209 of the Advisers Act to include a new provision confirming that aiders and abettors of securities law violations are liable to the same extent as the primary actor. This proposal would significantly expand liability under the antifraud provisions of the federal securities laws.

- **Investor Advisory Committee**: A new Investor Advisory Committee is created under the proposal, to be composed of members representing the interests of individual and institutional investors. The committee is to advise and consult with the SEC on:

  - regulatory priorities and issues regarding new products, trading strategies, fee structures and the effectiveness of disclosures;
  - initiatives to protect investor interest; and
  - initiatives to promote investor confidence in the integrity of the marketplace.

The Investor Protection Proposal also provides the SEC with authority to engage in consumer testing.

- **Arbitration**: The proposed legislation amends Section 15 of the Exchange Act and Section 205 of the Advisers Act to grant the SEC authority to restrict or condition the use of mandatory arbitration clauses by brokers, dealers or investment advisers.

A copy of the Investor Protection Proposal is available here.

Status

Neither of the proposals has been formally introduced in Congress. Since Congress will need to take up the proposals in legislation, it is unclear when and if the proposed legislation will be enacted, but it is anticipated that Congress will consider the proposals in the coming months. The SEC's Director of Investment Management testified on July 15, 2009 before a Senate Subcommittee in support of the registration of investment advisers to private investment funds and additional regulation of private funds. Given the recent administration and agency statements in support of private investment fund registration and other recent proposals in the House and Senate during the current session, it is likely that unregistered investment advisers to private investment funds will face registration and that registered and unregistered advisers will be subject to additional regulation in the near future.

Registered and unregistered advisers should study the new proposals, consider how the new proposals will impact their day-to-day operations and weigh in with their lobbying and government affairs advisers. In addition, unregistered investment advisers should familiarize themselves with the existing regulatory requirements, prepare for additional regulatory oversight and, as additional details regarding the proposed reporting and other obligations emerge, develop and refine appropriate compliance policies and procedures.

Additional Information

The Hunton & Williams Private Investment Fund practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings and compliance. We will continue to monitor the progress of these proposals as well as other relevant trends in private investment fund regulation.

The Hunton & Williams Government Relations team is equipped with the know-how and relationships to assist you in outreach to Congress if you would like to discuss your concerns regarding, and/or offer alternatives to, the proposals.

For additional information on recent proposals relating to regulation of private investment funds and their advisers, including the Obama administration's White Paper, see our prior memoranda available on www.hunton.com.

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