HUNTON& WILLIAMS

PRIVATE INVESTMENT FUND UPDATE

June 2009

Obama Administration Proposes Registration of Private Fund Advisers Following Recent Similar Proposals

On June 17, 2009, the Obama administration proposed a plan for Financial Regulatory Reform (the "White Paper") that addresses five key objectives identified by the Obama administration to reform the financial regulatory system. Certain of the White Paper's proposals, if enacted, will have a significant impact on private investment funds, such as hedge funds, private equity funds and venture capital funds, by requiring the registration of private investment fund advisers and by imposing informational and reporting requirements on the advisers and their funds.

The White Paper's Private Investment Fund Proposals

The White Paper's proposals relating to private investment funds and their advisers include:

Adviser Registration Requirement

The White Paper recommends that all advisers to private pools of capital, including hedge funds, private equity funds and venture capital funds, whose assets under management exceed some modest threshold should be required to register with the SEC under the Investment Advisers Act of 1940 (the "Advisers Act"), but does not specify the "modest threshold" that would trigger the adviser registration requirement. Depending on the threshold selected by Congress if it enacts the proposal, certain types of fund advisers with fewer assets under management may avoid this requirement. The White Paper also does not specify the mechanism for requiring adviser registration, but presumably it will involve the elimination of the private adviser exemption (also known as the "15 client" exemption) found in Section 203(b)(3) of the Advisers Act and Rule 203(b)(3)-1 thereunder.

Although general partners and managers to private investment 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.

Reporting Requirements

The White Paper appears to recommend reporting by advisers to the funds as well as with respect to the funds themselves. First, the White Paper recommends that advisers should be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability. Second, the White Paper recommends that all investment funds advised by a SEC-registered investment adviser should be subject to regulatory reporting requirements. The White Paper provides few details regarding these reporting requirements and it is not clear at this time whether, and to what extent, the reporting requirements will be duplicative of existing reporting requirements for registered investment advisers.

In addition, the White Paper specifically recommends that all funds managed by a SEC-registered investment adviser report on a confidential basis the amount of assets under management, borrowings, off balance sheet exposures and other information necessary to assess whether the fund or fund family is so large, highly leveraged or interconnected that it poses a threat to financial stability. Further, the SEC should share the reports that it receives from funds with the Federal Reserve, which should determine whether any of the funds or fund families meet the Tier 1 Financial Holding Company ("FHC") criteria and, if so, those funds should be supervised and regulated as Tier 1 FHCs. For additional information regarding the proposed supervision

and regulation of Tier 1 FHCs, see our memorandum, available here.

The lack of detail regarding the nature and extent of these potential reporting requirements raises a number of confidentiality and other concerns. For example, a number of funds and their advisers regard information such as assets under management, borrowings and off balance sheet exposures as sensitive competitive information. Disclosure of such information to the SEC and the SEC's sharing of such information with the Federal Reserve, even on a confidential basis, presents certain risks.

Recordkeeping Requirements

The White Paper recommends that all investment funds advised by a SEC-registered investment adviser should be subject to recordkeeping requirements. The White Paper does not specify whether these recordkeeping requirements would be duplicative of or in addition to the existing recordkeeping requirements under the Advisers Act or the Investment Company Act of 1940 (the "Investment Company Act").

Fund Disclosure Requirements

The White Paper recommends that all investment funds advised by a SEC-registered investment adviser should be subject to requirements with respect to disclosures to investors, creditors and counterparties. All investment advisers are subject to the antifraud rules of the Advisers Act and thus by implication are subject to certain threshold disclosure requirements with respect to investors in their funds. Until additional details are provided, we will not know the nature and extent of the new disclosure requirements with respect to investors, creditors and counterparties.

Compliance Examinations

The White Paper recommends that the SEC should conduct regular, periodic examinations of such funds to monitor compliance with the above requirements. The White Paper does not provide any additional detail regarding the timing or nature of the compliance examinations and, given the recent scrutiny of the SEC's examination process, it is not clear whether the new compliance examination process and requirements will deviate significantly from those currently applied to registered investment advisers.

Varying Requirements for Different Types of Investment Funds

Although the White Paper does not provide details as to whether and how hedge funds, private equity funds, venture capital funds and other types of funds may be treated in a different manner from each other, the proposals reference the possibility that certain requirements applicable to investment funds may vary across the different types of private investment pools.

Other Proposals with Impact on Private Funds

The White Paper also proposes broker-dealer reform to establish a fiduciary duty for broker-dealers offering investment advice and to harmonize the regulation of investment advisers and broker-dealers. Another notable proposal in the White Paper is the elimination of the federal thrift charter and the Office of Thrift Supervision. Private equity funds focused on acquisitions of such financial institutions may find the new regulator charged with approving such transactions less welcoming of private equity buyers. In addition, private investment funds that own assets or institutions covered by the new regulations will be subject to the new regulatory framework applicable to those assets and institutions.

Other Recent Proposals Relating to Private Investment Fund Regulation

The White Paper adds to the drumbeat of proposals this year from Congress and the Obama administration calling for additional regulation and oversight of the private investment fund industry, including:

- **Senate Proposal to Eliminate Private Adviser Exemption (S.1276)** — On June 16, 2009, Senator Jack Reed (D-RI) introduced S.1276, the "Private Fund Transparency Act of 2009," in the Senate to amend the Advisers Act to require all private investment fund advisers that manage more than $30 million in assets to register as investment advisers. S.1276 would eliminate the private adviser exemption found in Section 203(b)(3) of the Advisers Act and replace it with a more limited exemption for foreign private investment advisers. S.1276 would also provide the SEC with authority to collect and examine data from the private investment funds that SEC-registered advisers sponsor or otherwise advise. S.1276 was referred to the Senate Committee on Banking, Housing, and Urban Affairs.
- **Prior Administration Proposal** — On March 26, 2009, U.S. Secretary of the Treasury Timothy Geithner outlined a framework for regulatory reform that would require all advisers to private investment funds whose assets under management

exceed a certain threshold to register with the SEC. The proposal also would require disclosures to investors and counterparties and reporting, on a confidential basis, of information to asses the threat to financial stability. The March Geithner plan was the predecessor to the more detailed proposals of the White Paper.

- **Senate Proposal to Eliminate Section 3(c)(1) and 3(c)(7) Investment Company Act Exceptions (S.344)** — On January 29, 2009, S.344 was introduced in the Senate by Senators Chuck Grassley (R-Iowa) and Carl Levin (D-Michigan). S.344 proposed to delete the Section 3(c)(1) and 3(c)(7) "exceptions" from the definition of "investment company" under the Investment Company Act and largely restate them as "exemptions" from registration. "Large investment companies," those with assets under management of $50 million or more, would receive the benefit of the new "exemptions" only if they registered with the SEC and complied with other disclosure, reporting and examination requirements. S.344 was referred to the Senate Committee on Banking, Housing, and Urban Affairs.

- **House Proposal to Eliminate Private Adviser Exemption (H.R.711)** — A package of legislation introduced in the House of Representatives on January 27, 2009 by Representatives Michael Capuano (D-Massachusetts) and Michael Castle (R-Delaware) targeted the hedge fund industry but was broadly drafted also to cover other types of private investment funds such as private equity funds and venture capital funds. H.R.711 proposed eliminating in its entirety the private adviser exemption provided in Section 203(b)(3) of the Advisers Act and Rule 203(b)(3)-1 thereunder. H.R.711 was referred to the House Committee on Financial Services.

- **House Proposal to Require Additional Benefit Plan Disclosures of Fund Investments (H.R.712)** — H.R.712, included in the same package introduced by Representatives Capuano and Castle, proposed amending Section 103(b) of the Employee Retirement Income Security Act of 1974 (ERISA) to add new disclosure requirements for defined benefit pension plans, including the identity of and amounts invested in each unregistered investment pool permitted under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act and Section 4(2) of the Securities Act of 1933 (the "Securities Act") and Rule 506 and Regulation D thereunder. H.R.712 was referred to the House Committee on Education and Labor.

- **House Proposal for Study of the Fund Industry (H.R.713)** — H.R.713, also included in the same package introduced by Representatives Capuano and Castle, proposed directing the President's Working Group on Financial Markets to conduct a study of the hedge fund industry. H.R.713 was referred to the House Committee on Financial Services.

Global Developments

- **IOSCO Proposal for Registration/ Regulation of Hedge Funds and Their Financing Sources** — On June 22, 2009, the International Organization of Securities Commissions ("IOSCO") issued a report recommending six high level principles on the regulation of hedge funds, including the mandatory registration of hedge funds and/or their advisers, ongoing regulatory requirements for hedge funds and/or their advisers, the mandatory registration and regulation of prime brokers and banks that provide funding to hedge funds, and the cooperation and sharing of information among regulators.

- **G-20 Declaration to Regulate Systemically Significant Funds** — On April 2, 2009, the leaders of the Group of Twenty ("G-20"), including President Obama, met in London and issued a declaration endorsing, among other items, the extension of regulation and oversight over systemically important hedge funds. The White Paper highlights the leadership role of the United States in efforts, such as the G-20 Declaration, to coordinate international financial policy through the G-20 and states that the administration will use its leadership position to promote initiatives compatible with the domestic regulatory reforms outlined in the White Paper.

- **Proposed EU Directive for Managers of Alternative Investment Funds** — On April 29, 2009, the European Commission proposed a Directive on Alternative Investment Fund Managers

("AIFM") to apply to AIFM managing a portfolio of more than 100 million euros (or 500 million euros for AIFM not using leverage and having a five year lock-up period for investors). Such AIFM would be subject to ongoing regulation and governance standards. Only such regulated AIFM would be permitted to market their funds to professional investors throughout the European Union, subject to compliance with demanding regulatory standards. The proposed legislation was submitted to the European parliament and member states for consideration.

Conclusion

If the proposals outlined in the White Paper are enacted by Congress, private investment funds such as hedge funds, private equity funds and venture capital funds and their advisers will be subject to registration and additional regulation and supervision. Since Congress will need to take up the proposals in legislation, it is unclear when and if any particular proposal from the White Paper will be enacted. However, given the sweeping nature of the proposed changes and the volume of the drum-beat for additional regulatory oversight over investment advisers to hedge funds and other private funds, unregistered investment advisers to such funds should familiarize themselves with the existing regulatory requirements, prepare for additional regulatory oversight and, as additional details regarding the proposed reporting and compliance obligations emerge, develop 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 the White Paper's other proposals, see our related memoranda, available on www.huntonfinancialindustryrecovery.com. For additional information on recent proposals relating to regulation of private investment funds and their advisers, see our prior memoranda available on www.hunton.com.

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