HUNTON& WILLIAMS

PRIVATE INVESTMENT FUND UPDATE

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Senator Dodd's Proposed Legislation Would Impact Private Fund Advisers

On March 15, 2010, Senator Christopher Dodd (D-CT) unveiled a revised draft of proposed legislation, the "Restoring American Financial Stability Act of 2010" (the "RAFSA"), for consideration by the Senate Committee on Banking, Housing, and Urban Affairs. The RAFSA includes expansive financial industry regulatory reforms, including the "Private Fund Investment Advisers Registration Act of 2010" (the "PFIARA").[1] The PFIARA, as proposed by Senator Dodd, is similar to a prior version of the PFIARA included in H.R. 4173, which passed the House of Representatives on December 11, 2009. If passed by Congress and signed into law in its present form, the PFIARA could have a significant impact on advisers to certain private funds, including hedge funds, private equity funds and permanent capital vehicles, by (1) requiring the registration of certain unregistered advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and (2) imposing additional reporting and disclosure requirements on investment advisers, including those already registered under the Advisers Act. The Dodd version of the PFIARA lays out a framework for regulation of private fund advisors, but delegates to the SEC rulemaking authority for many of the details concerning the types of advisers that may face additional regulatory burden.

Changes to Investment Adviser Registration Exemptions

Elimination of Private Adviser Exemption: In a manner similar to the House version of the PFIARA, the Dodd version of the PFIARA 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. 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": Similar to the House version, the Dodd version of the PFIARA 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 exceptions from investment company status found in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act").

Venture Capital Exemption: As with the House version, the Dodd version of the PFIARA exempts advisers to "venture capital funds" from the registration requirements of the Advisers Act. The House version also requires the SEC to impose certain recordkeeping and reporting requirements on venture capital funds, while the Dodd version is silent on the matter of recordkeeping. Rather than defining the term "venture capital fund" itself, the PFIARA requires the SEC to issue final rules within six months of enactment of the PFIARA to define the term. While it is not clear how the SEC will ultimately define the term "venture capital fund," there is speculation that the term will be defined based on the size of the fund or a business strategy of investing in small or startup businesses.

Private Equity Exemption: In a departure from the House version of the PFIARA, the Dodd version exempts advisers to "private equity funds" from the registration requirements of the Advisers Act, but requires the SEC to issue final rules within six months of enactment to define "private equity fund" and to require such advisers to maintain records

[1] The current version of the RAFSA is available here. The PFIARA can be found in Title IV of the RAFSA.

and provide annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors, taking into account fund size, governance, investment strategy, risk and other factors. It is difficult to predict the SEC rulemaking, but there is speculation that the SEC will approach defining the term "private equity fund" in a manner similar to the definition of "private fund" used in connection with the so-called "Hedge Fund Rule" that was vacated in the *Goldstein v. SEC* case[2] in which a distinction was made among private funds based on the ability of investors to redeem interests in the fund.

Family Office Exemption: In another departure from the House version, the Dodd version of the PFIARA excludes "family offices" from the definition of "investment adviser" under Section 202(a)(11) of the Advisers Act. As a result, family offices would be excluded from coverage by the Advisers Act, including the registration, record keeping and reporting requirements to which such family offices might otherwise be subject upon the elimination of the private adviser exemption. Rather than defining the term "family office" itself, the PFIARA grants the SEC the discretion to define the term, but directs the SEC to fashion an exemption that "recognizes the range of organizational structures and management arrangements employed by family offices."

State Law Regulation: The Dodd version of the PFIARA increases the threshold for registration under the Advisers Act from $25 million in assets under management to $100 million in assets under management. As a result, any investment adviser with less than $100 million in assets under management will not be subject to federal regulation and the registration requirements under the Advisers Act, but instead will be subject to state investment adviser regulation. Rather than adjusting the state law regulation threshold, the House PFIARA includes a limited exemption from the Advisers Act registration requirements for investment advisers to private funds with assets under management in the United States of less than $150 million as well as a potential exemption for "mid-sized private funds" (a term that is not defined). The higher state law regulation threshold proposed by the Dodd PFIARA would require those investment advisers with between $25 million and $100 million in assets under management to register with state regulators, while under the House approach these advisers would remain subject to federal regulation but would be exempt from the registration requirements. Since many of these investment advisers are already registered with the SEC under the federal Advisers Act, this change would require these advisers to deregister with the SEC unless a grandfather provision is included. For those advisers that are not already registered with the SEC in reliance on the private adviser exemption, this change would require state registration subject to any available state exemptions.

Limited Exemption for "Foreign Private Advisers": Similar to the House version, the Dodd version of the PFIARA 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;
- has fewer than 15 clients who are domiciled in or residents of the United States;
- has assets under management attributable to clients who are domiciled in or residents of the United States of less than $25 million; 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.

Limited Exemption for SBICs: As with the House version, the Dodd version of the PFIARA adds a new limited exemption for investment advisers, other than business development companies, who solely advise (1) small business investment companies licensed under the Small Business Investment Act of 1958, (2) entities that have received from the Small Business Administration notice to proceed to qualify for a license, or (3) applicants related to one or more licensed small business investment companies that have applied for another license.

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. However, the Dodd version of the PFIARA, similar to the House version, amends the intrastate exemption to exclude from its coverage investment advisers to "private funds."

Changes to Reporting Requirements

Information Gathering and Sharing: Similar to the House version, the Dodd version of the PFIARA authorizes

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

the SEC to require registered investment advisers to private funds to maintain such records and file such reports regarding the private funds they advise as are necessary or appropriate for the protection of investors or for the assessment of systemic risk by the newly established Financial Stability Oversight Council ("Council"), to consist of the Secretary of the Treasury, the Chairman of the SEC and the heads of various other financial regulatory bodies. The required records and reports for each private fund include a description of:

- the amount of assets under management and use of leverage;
- counterparty credit risk exposures;
- trading and investment positions;
- valuation policies and practices of the fund;
- types of assets held;
- side arrangements or side letters;
- trading practices; and
- such other information as the SEC in consultation with the Council determines necessary or appropriate in the public interest and for the protection of investors for the assessment of systemic risk, which may include the establishment of different reporting requirements for different classes of fund advisers based on the type or size of private fund being advised.

The recordkeeping and reporting requirement regarding valuation policies and practices of the fund, the types of assets held and side arrangements or side letters were not included in the House version of the PFIARA. Such records will be subject to periodic and special examinations by the SEC.

The PFIARA also requires the SEC to share reports, documents, records and information with the Council to the extent the Council deems necessary for the purposes of assessing the systemic risk of a private fund.

Confidentiality of Reports: The Dodd version of the PFIARA provides that any "proprietary information" of an investment adviser ascertained by the SEC from any report required to be filed under the Advisers Act shall not be subject to public disclosure and shall be exempt from Freedom of Information Act ("FOIA") disclosure requirements. "Proprietary information" includes:

- sensitive, non-public information regarding the investment or trading strategies of the investment adviser;
- analytical or research methodologies;
- trading data;
- computer hardware or software containing intellectual property; and
- any additional information that the SEC determines to be proprietary.

The House version of the PFIARA includes a less detailed requirement that reports, documents and information obtained by federal agencies shall be kept confidential and also includes a clarification, not included in the Dodd version, that investment advisers shall not be compelled to waive, and shall not be deemed to have waived, any privileges applicable to information disclosed to federal agencies. Both the House and Dodd versions of the PFIARA, however, provide that the SEC may not withhold information from Congress, nor shall the SEC be precluded from complying with a request for information from any other federal department or agency or an order of a court of the United States in an action brought by the United States or the SEC. The lack of significant confidentiality protections in the PFIARA for sensitive proprietary information may present a new business dynamic for private funds.

Disclosure of Client Information: Under the Dodd version of the PFIARA, the SEC may require an investment adviser to disclose the identity and investments of clients "for purposes of assessment of potential systemic risk." The House version of the PFIARA deletes in its entirety any limitation on the SEC's ability to require disclosure of the identity, investments or affairs of the investment adviser's clients. This represents a significant departure from the current Advisers Act, which permits the SEC to require disclosure of client information only in connection with an enforcement proceeding or investigation.

Additional PFIARA Changes

Custody of Client Assets: In a departure from the House version, the Dodd version of the PFIARA adds a new provision to the Advisers Act requiring registered investment advisers to take such steps to safeguard client assets over which the adviser has custody, including verification of client assets by independent public accountants and such other client protections as the SEC may prescribe by rule. The SEC issued new final custody rules in December 2009, requiring a registered investment adviser to (1) undergo an annual surprise examination by an independent public accountant to verify client assets, (2) have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients, and (3) unless client assets are maintained

by an independent custodian, obtain a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board. Since the SEC adopted its new custody rules prior to the release of the Dodd version of the PFIARA, one may assume that Congress expects to see additional rulemaking from the SEC regarding custody safeguards.

Accredited Investor Standard Adjustment: The Dodd version of the PFIARA also directs the SEC to adjust the "accredited investor" standard under the Securities Act of 1933, as amended (the "Securities Act"), to account for inflation and to revisit such standard on a periodic basis going forward. The House version of the PFIARA requires the SEC to update any exemptions in the Advisers Act based on dollar thresholds (such as those included in the definition of "qualified client" in Rule 205-3) within one year of enactment and every five years thereafter, but does not expressly reference the accredited investor standards in the Securities Act.

Commodity Futures Trading Commission: Similar to the House version, the Dodd version of the PFIARA also requires the SEC and the Commodity Futures Trading Commission ("CFTC") to 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.

GAO Studies: While the House version of the PFIARA includes a provision requiring a cost study assessing the annual costs to industry members and their investors due to the registration and reporting requirements, the Dodd version of the PFIARA requires the Comptroller General to carry out a number of studies, including studies assessing:

- accredited investor standards;
- the feasibility of a self-regulatory organization to oversee private funds, private equity funds and venture capital funds; and
- short selling practices.

The inclusion of a requirement for a study regarding a self-regulatory organization to oversee private funds, private equity funds and venture capital funds indicates that there is a potential for additional regulation of these types of funds and/or their advisers. The Comptroller General must report the results of such studies to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services.

Transition Period and Effective Date: The PFIARA provides that it will be effective one year after enactment, but that investment advisers may register before the effective date.

Additional RAFSA Reforms Impacting Private Funds

Volcker Rule: The RAFSA also includes the "Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010," which proposes, among other things, to prohibit banks, bank holding companies and their subsidiaries from sponsoring or investing in a "hedge fund" or "private equity fund" or from entering into a "covered transaction" (including loans, purchases of assets or securities and guarantees) with a hedge fund or private equity fund (the "Volcker Rule"). The terms "hedge fund" and "private equity fund" are loosely defined in a manner similar to the new "private fund" definition under the PFIARA as Section 3(c)(1) and 3(c)(7) funds. The RAFSA requires the Council to conduct a study of the Volcker Rule to be completed within six months of the enactment of RAFSA. Within nine months of the completion of such study, the "appropriate Federal banking agencies" must jointly issue final regulations implementing the Volcker Rule.

Regulation D: The RAFSA also includes a provision to allow increased state regulation of private securities offerings exempt from registration pursuant to Regulation D of the Securities Act. Under RAFSA, the SEC may designate by rule a class of securities that it deems not to be "covered securities" subject to federal preemption because the offering is not of sufficient size or scope. In addition, in the event the SEC does not review a Form D notice filing regarding a private securities offering within 120 days of filing, a state securities commission may review such filing for compliance. Further, a state securities commission may also require its own notice filing procedure in addition to the Form D notice filing requirement of the Securities Act. These changes will increase the compliance burden associated with raising private fund capital in an exempt securities offering.

Status

The RAFSA draft was unveiled by Chairman Dodd on March 15, 2010, and the Senate Committee on Banking, Housing, and Urban Affairs is scheduled to begin marking up the draft RAFSA and any amendments on Monday, March 22, 2010. Chairman Dodd has asked that all amendments be submitted by Friday, March 19, 2010. Both moves by Chairman Dodd are designed to achieve his goal of

voting the draft RAFSA out of committee on March 26, 2010. It is unclear if Chairman Dodd will achieve his scheduled goal. If the RAFSA is voted out of committee and reported to the full Senate, it could be further amended. If the full Senate approves the RAFSA, the next step is for the House and Senate conference committee to reconcile it with H.R. 4173, also known as the Frank bill. Although the PFIARA included in the Dodd draft is similar to the House version of the PFIARA included in H.R. 4173, there are some notable differences that would need to be reconciled, including among others:

- the House version does not include the exception for family offices;
- the House version does not include the exemption for private equity funds included in the Dodd draft;
- the House version includes a limited exemption from the registration requirements for investment advisers to private funds with assets under management in the United States of less than $150 million as well as a potential exemption for "mid-sized private funds" (a term that is not defined). The Dodd version does not include this limited $150 million exemption or the potential exemption for "mid-sized private funds" but rather increases the threshold for federal regulation from $25 million to $100 million;
- the House version includes an additional limitation on the Advisers Act's commodity trading adviser exemption;
- the House version includes a provision clarifying that investment advisers will not be compelled to waive privileges applicable to data disclosed to regulatory authorities; and
- the House version permits the SEC to ascribe different meanings to terms in the Advisers Act but does not permit the SEC to define the term "client" to include investors in a private fund managed by the investment adviser.

Given administration and SEC statements in support of private investment fund registration, the number of other recent proposals during the current session, and current focus on financial industry reform, it is likely that most 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 legislation and consider how the legislation will impact their day-to-day operations. 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.

Further 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, secondary sales and compliance. We will continue to monitor the progress of this legislation and other relevant trends in private investment fund regulation.

During this period of challenge and rapid change in the financial industry, financial institutions and other financial services companies need advisors with broad experience and an understanding of the full range of business and legal issues associated with current market and regulatory changes. The Hunton & Williams Government Relations team is focused on legislative developments relating to financial industry reform and 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 financial industry recovery 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 our website at www.hunton.com.

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