Hunton & Williams

Private Investment Fund Update

July 2010 Analysis of the Dodd-Frank Wall Street Reform Act

Dodd-Frank Act Impacts Private Fund Advisers

On July 15, 2010, the Senate approved the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Act"), previously passed by the House on June 30, 2010. President Obama is expected to sign the Act into law on July 21, 2010. The Act includes expansive financial industry regulatory reforms, including the "Private Fund Investment Advisers Registration Act of 2010" (the "PFIARA").[1] The PFIARA is similar to a prior version of the PFIARA introduced by Sen. Christopher Dodd (D-CT) in the Senate in March and included in H.R. 4173, which was originally passed by the House on December 11, 2009. The PFIARA will have a significant impact on advisers to certain private funds, including hedge funds, private equity funds, venture capital funds and various other investment 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 PFIARA lays out a framework for regulation of private fund advisers, but delegates to the Securities and Exchange Commission ("SEC") rulemaking authority for many of the details concerning the types of advisers that will be facing additional regulatory burden. As a result, private investment fund advisers will need to run their businesses with a renewed focus on compliance.

[1] The PFIARA can be found in Title IV of the Act.

SEC Registration Requirement; Elimination of Private Adviser Exemption

The PFIARA eliminates the private adviser registration exemption found in Section 203(b)(3) of the Advisers Act (also known as the "15 client" exemption). Many investment advisers to hedge funds, private equity funds, venture capital funds and other investment vehicles 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, once 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, record-keeping, advisory contracts, performance fees, ethics and personal trading policies, investment and financial reporting and advertising. In addition, there may be advisers to a number of other types of investment vehicles that may have previously relied on the private adviser exemption that will become subject to the registration and other requirements of the Advisers Act. There also may be other advisers, such as advisers to real estate funds and mortgage REITs, that have relied on the private adviser exemption as an alternative to a more thorough review of available exemptions that will now need to engage in a more in-depth analysis of their business to determine whether registration will be required.

Exemptions from SEC Registration

In place of the broader private adviser exemption, the PFIARA implements several narrower exemptions and reduces the scope of some existing exemptions, which are outlined below.

Private Fund Size Exemption

The PFIARA exempts advisers that advise solely "private funds" and have assets under management in the U.S. of less than $150,000,000. While these investment advisers are exempt from the registration requirements of the Advisers Act, they nonetheless are required to maintain such records and provide to the SEC such reports as the SEC determines necessary or

appropriate. The term "private fund" is defined to include any 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").

In addition, the PFIARA directs the SEC, when prescribing regulations generally, to take into account the size, governance and investment strategy of "mid-sized private funds." Because Congress did not define the term "mid-sized private fund," it is not clear what advisers will be covered or how the disclosure and other regulations under the Advisers Act will differ for such advisers.

Venture Capital Exemption

The PFIARA exempts advisers that advise solely one or more "venture capital funds" from the registration requirements of the Advisers Act but requires such advisers to maintain such records and provide to the SEC such annual or other reports as the SEC determines necessary or appropriate. Rather than defining the term "venture capital fund" itself, the PFIARA requires the SEC to issue final rules within one year 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" and whether it will encompass venture capital funds-of-funds, one may assume that the term will be defined based on the size of the fund or a business strategy of investing in small or startup businesses.

Family Office Exemption

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 they 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 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." Family offices that rely on grandfather provisions will be subject to antifraud provisions of Sections 206(1), (2) and (4) of the Advisers Act.

Limited Exemption for "Foreign Private Advisers"

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 and investors in the United States in private funds advised by the investment adviser;
- has aggregate assets under management attributable to clients in the United States in private funds advised by the investment adviser of less than $25 million or such higher amount as the SEC may by rule deem appropriate; 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.

While the statutory language is not completely clear, it appears the foreign private adviser exemption applies to both advisers to private funds and advisers to traditional clients accounts, provided that the total of US investors in private funds advised by such adviser plus other US clients advised by such an adviser is less than 15. Due to the narrow scope and size limitations of the foreign private adviser exemption, many offshore fund advisers will not be able to take advantage of it.

Commodity Trading Exemption

The PFIARA includes an exemption for advisers registered as commodity advisers with the Commodity Futures Trading Commission ("CFTC") and that advise a private fund. The exemption provides, however, that if the business of the adviser becomes predominantly the provision of "securities-related" advice, then such adviser must register with the SEC.

Limited Exemption for SBICs

The PFIARA adds a new limited exemption for investment advisers, other than business development companies, that advise solely (i) small business investment companies licensed under the Small Business Investment Act of 1958, (ii) entities that have received from the Small Business Administration notice to proceed to

qualify for a license, or (iii) applicants related to one or more licensed small business investment companies that have applied for another license.

Private Equity Exemption Removed

The PFIARA does not include the exemption from the registration requirements of the Advisers Act for advisers to "private equity funds" that was originally included in the Senate version of the legislation passed on May 20, 2010.

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 intrastate exemption has been amended to exclude from its coverage investment advisers to "private funds."

State Law Regulation

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, unless the investment adviser would be required to register with 15 or more states. 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. Since many of these investment advisers are already registered with the SEC under the federal Advisers Act, this change would require these advisers to de-register with the SEC. For those advisers that are not already registered with the SEC in reliance on the private adviser exemption, this change will require state registration subject to any available state exemptions. In addition, Section 928 of the Act adds a clarification that the Advisers Act Section 205 limitations on performance compensation do not apply to state-registered advisers.

Reporting Requirements

Information Gathering and Sharing

The PFIARA authorizes 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 new Financial Stability Oversight Council ("Council") created under the Act, 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 the private fund being advised.

Records regarding valuation policies and practices of the fund, the types of assets held and side arrangements or side letters 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. These additional disclosure requirements likely will facilitate additional SEC scrutiny of potential conflicts of interest, investor disclosures and valuation matters. The additional attention also may bring an increased risk of an enforcement action. Further, the Council may use this information in determining whether an adviser or fund should be subject to additional regulation and prudential supervision under Title I of the Act.

Confidentiality of Reports

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.

Many private equity fund advisers will likely want clarification that portfolio-specific information will also be considered proprietary. The SEC may not withhold information from Congress, nor will 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.

Disclosure of Client Information

Under 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." This represents a significant departure from the current Advisers Act provision, 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

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 PFIARA, one may assume that Congress expects to see additional rulemaking from the SEC regarding custody safeguards.

Accredited Investor and Qualified Client Standard Adjustment

The PFIARA also directs the SEC to adjust the "accredited investor" standard under the Securities Act of 1933, as amended (the "Securities Act"), (i) to exclude an individual's primary residence from the calculation of the $1 million net worth requirement, (ii) to adjust monetary thresholds to account for inflation, and (iii) to revisit the accredited investor standard every four years going forward. In addition, the PFIARA requires the SEC to update any exemptions in the Advisers Act based on dollar thresholds (such as a net asset threshold or those included in the definition of "qualified client" in Rule 205-3) within one year of enactment and every five years thereafter. These changes will have a greater impact on Section 3(c)(1) funds, because Section 3(c)(7) fund investors must satisfy the higher "qualified purchaser" thresholds.

"Client" Definition

The PFIARA includes a provision that prohibits the SEC from defining the term "client" for purposes of the antifraud rules in Section 206(1) and (2) of the Advisers Act to include the investors in a private fund if the fund has entered into an advisory contract with the investment adviser. This provision may limit the extension of an investment adviser's fiduciary duties to its fund's investors.

Commodity Futures Trading Commission

The PFIARA requires the SEC and the 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

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 and requires the Comptroller General to carry out a number of additional studies, including studies assessing:

- costs associated with client custody rules;
- accredited investor standards;

- the feasibility of a self-regulatory organization to oversee private funds; and
- short selling practices.

The inclusion of a requirement for a study regarding a self-regulatory organization to oversee private 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.

Other Aspects of the Act Impacting Private Funds

Regulation D

Section 926 of the Act includes a provision prohibiting the offer and sale of securities in Regulation D exempt offerings by felons and other "bad actors," including individuals convicted of misdemeanors in connection with the offer and sale of securities. This provision reflects a significant change from the original Senate version of the Act, which would have increased state regulation of private securities offerings pursuant to Regulation D.

Investment Adviser Incentive Compensation Arrangements

Section 956 of the Act includes a provision relating to enhanced compensation structure reporting by "covered financial institutions," which are defined to include investment advisers and registered broker-dealers. This provision requires that the Federal Reserve, the SEC and other federal regulators jointly prescribe regulations within nine months of enactment to require each covered financial institution to disclose the structures of all incentive-based compensation arrangements offered by that institution sufficient to determine whether the compensation structure provides excessive compensation, fees or benefits to an executive officer, employee, director or principal shareholder of the institution, or could lead to material financial loss to the institution. In addition, the regulators are required to jointly prescribe regulations that prohibit any incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks by covered financial institutions by providing excessive compensation, fees or benefits or that could lead to material financial loss to the institution. The provision does not apply to covered financial institutions with assets of less than $1 billion. It is unclear whether this exemption refers to the direct assets of investment advisers or to the assets under management by investment advisers. It is also not yet clear how the incentive allocations and performance fee structures charged by private investment funds will be impacted under the regulations to be promulgated by the federal regulators.

Standards of Conduct Applicable to Retail Customers

Section 913 of the Act includes provisions:

- requiring a study and additional rulemaking potentially impacting any investment adviser providing personalized investment advice to a "retail customer" (including natural persons who receive personalized investment advice and use such advice primarily for personal, family or household purposes);
- permitting the SEC to promulgate rules providing that the standard of conduct of brokers, dealers and investment advisers when providing personalized investment advice to retail customers (and such other customers as the SEC may by rule provide) shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice;
- requiring disclosures of any material conflicts of interest and permitting consent by the customer; and
- requiring the SEC to enhance disclosure requirements and examine and promulgate rules prohibiting or restricting certain sales practices, conflicts of interest and compensation schemes for brokers, dealers and investment advisers.

Arbitration

Section 921 of the Act amends 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.

Whistleblower Incentives

Section 922 of the Act adds a new Section 21F to the Securities Exchange Act of 1934, providing for a reward of 10-30 percent of the total monetary sanctions for whistleblowers in SEC actions under the securities laws that result in monetary sanctions exceeding $1 million. The new provisions not only facilitate the SEC's use of rewards, but also permit their use in a broader range of SEC enforcement actions.

Aiding and Abetting Liability

Section 929N of the Act amends Section 209 of the Advisers Act to include a new provision confirming that any person who knowingly or recklessly has aided or abetted a violation of securities laws is liable to the same extent as the primary actor. This provision represents a significant expansion of liability under the antifraud provisions of the federal securities laws.

Additional SEC Enforcement Powers

Title IX provides the SEC with additional enforcement powers and remedies, including expanded subpoena power, additional flexibility in civil proceedings, additional extraterritorial jurisdiction, and flexibility with respect to collateral bars.

Additional Studies

Title IX of the Act, the "Investor Protection and Securities Reform Act of 2010," requires several additional studies potentially impacting investment advisers, including studies:

- by the SEC regarding the need for enhanced examination and enforcement resources for investment advisers;
- by the SEC regarding the financial literacy of investors;
- by the Comptroller General regarding mutual fund advertising; and
- by the SEC regarding ways to improve investor access to registration information about investment advisers, brokers, dealers and their associated persons.

The inclusion of these studies indicates that there is a potential for additional regulation regarding examination, enforcement and advertising by investment advisers.

Impact

As a result of the PFIARA and subject to additional SEC rulemaking articulating the details of the remaining registration exemptions, it appears that many private investment fund managers with more than $150 million in assets under management in the United States will need to register with the SEC. Many of these firms, particularly the larger ones, have already registered for a variety of reasons, not the least of which is the sense that the limited partner community, particularly ERISA or other fiduciary investors, have a strong preference for investing with registered investment advisers. However, there are likely to be many middle-market fund managers and newer fund managers now needing to register as a result of the PFIARA. In addition, the new Advisers Act regulations will require fund advisers to expand their compliance framework with an eye to enhancing disclosures and the culture of compliance. Registered and unregistered advisers should study the legislation and the forthcoming regulations and consider how they will impact their day-to-day operations. Further, investment advisers should 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 PFIARA and regulations promulgated thereunder and other relevant trends in private investment fund regulation.

For additional information on financial industry recovery proposals, see our related memoranda, available on 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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