Hunton & Williams

Private Investment Fund Update

February 2010

House Passes Private Fund Investment Advisers Registration Act of 2009; Senate Banking Committee Draft Expected in Next Few Weeks

On December 11, 2009, the U.S. House of Representatives passed H.R. 4173, "The Wall Street Reform and Consumer Protection Act of 2009." H.R. 4173 includes expansive financial industry regulatory reforms, including the "Private Fund Investment Advisers Registration Act of 2009" (the "PFIARA"), which is similar to reform proposed by the Obama administration on July 10, 2009.[1] If passed by the Senate and signed into law in its present form, the PFIARA 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 many 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.

Changes to Investment Adviser Registration Exemptions

Elimination of Private Adviser Exemption

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. The elimination of the private adviser exemption would require all investment advisers with $30 million in assets under management to register with the SEC, subject to limited exemptions described below. 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 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 exemption from investment company status found in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act").

Limited Exemption for Private Fund Advisers of Smaller Private Funds

The PFIARA includes a limited exemption from the registration requirements for any investment adviser of private funds, if the investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150 million. Although exempt from the registration requirements, such investment advisers will be required to maintain records and provide the SEC such annual or other reports as the SEC determines necessary or appropriate in the public interest for the protection of investors.

Potential Exemption for Advisers to "Mid-Sized" Funds

The PFIARA directs the SEC, in prescribing regulations with respect to investment advisers acting as investment advisers to "mid-sized" private funds, to consider the size, governance, and investment strategy of such funds to assess whether they pose systemic risk, and to provide for registration and examination procedures with respect to such investment advisers that reflect the level of systemic risk posed by such funds. At this time it is unclear what

[1] Read H.R. 4173. The PFIARA can be found in Title V, Subtitle A of H.R. 4173.

constitutes a "mid-sized" fund and to what extent investment advisers to mid-sized funds will be subject to a lesser variety of registration and regulation under the Advisers Act.

Venture Capital Exemption

The PFIARA also exempts advisers to "venture capital funds" from the registration requirements of the Advisers Act, but requires such advisers to maintain records and provide annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors. Rather than defining the term "venture capital fund" itself, the PFIARA grants the SEC the discretion to define the term and, at this time, it is unclear how broadly or narrowly it will be defined.

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;
- during the preceding 12 months has had fewer than 15 clients and investors in the United States in private funds advised by the investment adviser and aggregate assets under management attributed to clients and investors 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 deem appropriate in the public interest or for the protection of investors; 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

The PFIARA adds a new limited exemption for investment advisers that 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), remains in place for investment advisers whose clients are all residents of the state in which the investment adviser maintains its principal place of business. But the PFIARA amends the intrastate exemption to exclude from its coverage investment advisers to "private funds."

Contraction of Exemption for Commodity Trading Advisers

The PFIARA 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."

Consideration of Risk; Potential Regulation of Funds

The PFIARA directs the SEC to take into account the relative risk profile of different classes of private funds as it establishes, by rule or regulation, the registration requirements of private funds. This provision leaves open the possibility that the private funds themselves (rather than solely the investment advisers to private funds) will be required to register or at least be subject to some additional forms of regulation. The regulatory focus on private funds is also reflected in the PFIARA's reporting requirements described below under "Changes to Reporting Requirements—Information Gathering and Sharing."

Changes to 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 as the SEC determines in consultation with the Federal Reserve. The required records and reports for each private fund include:

- 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, the SEC may require reporting of such additional information as it deems necessary. Investment advisers also will be required to maintain records of private funds and 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 Federal Reserve and any other entity that the SEC identifies as having systemic risk responsibility, for the purposes of assessing the systemic risk of a private fund.

Confidentiality of Reports

Although the PFIARA indicates that the reports, documents, records and information obtained by the Federal Reserve shall be kept "confidential" and that the SEC may not compel a private fund to disclose sensitive, non-public information regarding the investment adviser's investment or trading strategies and other proprietary information, the PFIARA 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 PFIARA as sensitive competitive information. The lack of significant confidentiality protections in the PFIARA for this information may present a new business dynamic for private funds.

Client-Related Disclosures

The PFIARA 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.

Applicable Privileges Not Waived

With regard to disclosed data and information, the PFIARA clarifies that investment advisers shall not be compelled to waive, and shall not be deemed to have waived, any privileges applicable to data or information disclosed to the Financial Services Oversight Council, the SEC, any federal financial regulator or state financial regulator, in any capacity, or any other agency of the federal government.

Additional Changes

Inflation Adjustment

The PFIARA also includes a provision requiring the SEC to update any exemptions 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 to adjust for the effects of inflation on such test.

Rulemaking Authority

The PFIARA amends Advisers Act Section 211 to expand the SEC's rulemaking authority so that it may classify persons or matters within its jurisdiction based on size, scope, business model, compensation scheme or potential to create or increase systemic risk. The amendment permits the SEC to ascribe different meanings to terms used in different sections of the Advisers Act as the SEC determines is necessary, but the SEC may not define the term "client" to include investors in a private fund managed by an investment adviser where the fund has entered into an advisory contract with the investment adviser. The PFIARA 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.

Cost Study

The PFIARA also requires the Comptroller General to carry out a study assessing the annual costs to industry members and their investors due to the registration and reporting requirements and to submit a report on its findings within two years of enactment of the PFIARA.

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.

Status

The PFIARA was introduced in the Senate on January 20, 2010, and has been referred to the Senate Banking, Housing, and Urban Affairs Committee. As of this writing, teams of senators are working on draft legislation. It is not yet clear whether the Senate Banking Committee will focus on the PFIARA as passed by the House or whether it will take up a discussion draft circulated by the Senate Banking Committee Chairman, Senator Christopher Dodd (D-CT), in November 2009, which is similar to the House bill but with some notable differences, such as the inclusion of a limited exemption for "private equity funds" from the registration (but not the recordkeeping) requirements and an increased registration threshold for assets under management of $100 million. It is unclear if and when investment adviser registration legislation will be approved by the Senate Committee, but it is

anticipated that the Senate will consider legislation in the coming weeks.

Given the recent administration and SEC statements in support of private investment fund registration, the number of other recent proposals during the current session, and current prioritization by the Senate of 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.

Additional Recent Developments

Taxation of Carried Interest as Ordinary Income

On February 1, 2010, the U.S. Department of Treasury released the General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, which includes a provision to change the tax treatment of carried interest, effective for taxable years beginning after December 31, 2010. On December 9, 2009, the U.S. House of Representatives passed the Tax Extenders Act of 2009 (H.R. 4213), which includes a similar provision, effective generally for taxable years ending after December 31, 2009. The carried interest provisions are consistent with the proposal included in the President's Fiscal Year 2010 Budget and proposal passed the House of Representatives on two previous occasions.

Volcker Rule

On January 21, 2010, President Obama announced a controversial proposal branded the "Volcker Rule" after former Federal Reserve Chairman Paul Volcker. The proposal would ban banks from owning, investing in or sponsoring hedge funds, private equity funds or proprietary trading operations for their own profit. No legislation has been formally introduced, however Mr. Volcker appeared before the Senate Banking Committee on February 2, 2010 and it is apparent that legislative language will be forthcoming in the wake of his testimony.

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

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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