

Funds

E-ALERT

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REGISTRATION OF ADVISERS TO PRIVATE INVESTMENT FUNDS

Yesterday the Obama Administration delivered proposed legislation to Capitol Hill that would require most investment advisers to hedge funds, private equity funds and other private investment funds to register with the Securities and Exchange Commission under the Investment Advisers Act of 1940 (the "Advisers Act"). In addition, registered investment advisers that manage private investment funds would be required to comply with new disclosure, recordkeeping, and reporting requirements regarding such funds.

THE PROPOSED LEGISLATION

Key elements of the proposed legislation are summarized below:

- The existing exemption from registration for investment advisers with fewer than 15 clients would be eliminated.¹ As a result, subject to certain exceptions, all investment advisers with at least \$30 million in assets under management would be required to register with the SEC under the Advisers Act.²
- Registered investment advisers that manage "private funds" - i.e., funds exempt from registration as investment companies under either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940³ - would be required to comply with new recordkeeping, SEC reporting and disclosure requirements regarding such funds.
 - Registered investment advisers would be required to keep records and make reports to the SEC regarding the private funds they advise; such reports and records would be designed to provide regulators with information necessary for the protection of investors or to assess the systemic risk posed by such funds.
 - At a minimum, these reports to the SEC would cover the amount of fund assets under management, the use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading and investment positions, and trading practices.

¹ In general, a typical "blind pool" fund is treated as a single client (regardless of how many investors invest through the fund). (See Section 203(b)(3) of the Advisers Act.) As a result, fund managers that manage 14 or fewer funds have been exempt from registration under the "fewer than 15 clients" exemption.

² Certain other existing exemptions from registration would be preserved, although investment advisers to private funds would no longer be entitled to rely on the exemption available for advisers having clients only in a single state. Under a new exemption, investment advisers with no place of business and de minimis activity in the United States, so-called "foreign private advisers," would not be required to register under the Advisers Act.

³ Section 3(c)(1) is available for funds owned by 100 or fewer investors, and Section 3(c)(7) generally is available for funds owned solely by "qualified purchasers." These exceptions also permit ownership by certain knowledgeable employees.

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- The SEC would also be authorized to issue rules requiring registered investment advisers to provide reports, records and other documents to investors, prospective investors, counterparties, and creditors of any private funds advised by such advisers.
- While the precise scope of these requirements will be determined through the SEC's rulemaking process, the Administration's "white paper" stated that it may be appropriate to vary some of these requirements based on type or category of fund.⁴
- Not surprisingly and as with all registered investment advisers, the records maintained by registered investment advisers for their private funds would be subject to regular, periodic examinations by the SEC.
- The SEC would make available the information it receives regarding private funds to the Federal Reserve and the proposed Financial Services Oversight Council, to enable the Federal Reserve and such Council to assess the systemic risk of a private fund, and to assess whether any such private fund should be designated a "Tier 1 financial holding company." (Under a separate Administration proposal, Tier 1 financial holding companies would be subject to prudential supervision and regulation by the Federal Reserve, including capital, liquidity, and risk management requirements which could be stricter than the requirements that apply to regulated depository institutions. Tier 1 financial holding companies would also be subject to the full range of prudential regulations, supervisory guidance, and limitations on nonfinancial activities applicable to bank holding companies.)⁵
- Information regarding private funds required to be filed with the SEC will be kept confidential by the SEC, except in the case of requests for information by Congress and by other Federal departments or agencies or self-regulatory organizations.⁶

REGISTRATION UNDER THE ADVISERS ACT

If enacted, the proposed legislation will increase administrative/compliance burdens and expenses for a large class of previously unregistered investment advisers, i.e., those that have been exempt from registration under the "fewer than 15 clients" exemption under the Advisers Act. The registration process itself, while not unduly cumbersome or time-consuming, brings the adviser within a system of rules under the Advisers Act that includes the following:

- a requirement to file Form ADV with the SEC, as well as annual updates describing, among other things, the business practices, ownership and disciplinary history of the adviser;
- the need to provide an investment brochure to the adviser's clients;

⁴ See U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* (Jun. 17, 2009) at 37. In testimony before the Subcommittee on Securities, Insurance and Investment of the Senate Banking Committee on July 15, 2009, Andrew J. Donohue, Director of the SEC's Division of Investment Management echoed this point, stating that new requirements "should acknowledge the differences in the business models pursued by different types of private fund advisers and should address in a proportionate manner the risks to investors and the markets raised by each."

⁵ Further, private funds that are Tier 1 financial holding companies and which experience severe difficulties could be subject to the proposed resolution authority to be vested in the Treasury, pursuant to which the private fund could be placed into conservatorship or receivership or otherwise resolved.

⁶ It would be logical that the information provided to the SEC regarding private funds would not be subject to discovery through the Freedom of Information Act process. But, this issue will await further clarification during the legislative and subsequent SEC rulemaking processes. Such clarification may also address whether the SEC will permit confidential treatment requests in special circumstances, such as those involving privacy or competitive factors.

- certain restrictions on fees that the adviser may charge clients, including certain limitations on performance-based compensation, and restrictions on fees that can be paid to third party solicitors of clients;⁷
- for advisers with custody over client assets, a requirement to provide clients with audited financial statements (the SEC has an outstanding proposal to add tougher rules in this area);
- a requirement to inform clients of the adviser's proxy voting practices;
- a requirement to adopt a compliance system to govern the adviser's operations, including policies and procedures designed to prevent violations of the securities laws and the designation of a chief compliance officer to administer these policies; and
- a heightened system of liability standards.

These registration, compliance and liability aspects will be new challenges for previously unregistered investment advisers. All advisers to private funds, including those that have been previously registered, will also face the burdens of the new recordkeeping, reporting and disclosure requirements described above.

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⁷ As a practical matter, the restrictions on performance-based compensation for advisers should not have a significant effect on compensation schemes at most private funds, including the use of carried interest. However, this restriction will likely limit the use of such compensation arrangements at funds that are exempt from the Investment Company Act under Section 3(c)(1) (100 or fewer investors), at least insofar as such funds include non-US investors that are not "qualified clients" or "qualified purchasers" (which funds might include "friends and family" 3(c)(1) funds that invest alongside 3(c)(7) funds).