DÉJÀ VU ALL OVER AGAIN: PROPOSAL FOR PRIVATE FUND ADVISER REGISTRATION

July 17, 2009

To Our Clients and Friends:

On July 15, the Obama Administration unveiled proposed legislation, the Private Fund Investment Advisers Registration Act of 2009 (the "Registration Act"), to require investment advisers of private equity funds, hedge funds and other private investment funds, with very few exceptions, to register as investment advisers with the U.S. Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940 (the "Advisers Act"). Our clients will recall the SEC's 2004 attempt to require registration of advisers to private funds, which was overturned in a 2006 decision by the D.C. Court of Appeals. The proposed legislation, which is intended to implement recommendations that were contained in the Treasury Department's June 17 White Paper on Financial Regulatory Reform (the "White Paper"), would:

- Require most private fund advisers to register with the SEC;
- Mandate disclosure to the SEC and the Board of Governors of the Federal Reserve System (the "Federal Reserve") of "systemic risk data" about the funds managed by private fund advisers;
- Require private fund advisers to maintain books and records relating to their private funds under rules to be specified by the SEC; and
- Mandate that private fund advisers provide reports and other information to investors, counterparties and creditors of private funds they advise.

It is noteworthy that the proposed legislation, while encompassing some of the points relating to systemic risk and expanded regulation of alternative fund advisers agreed to by the G-20, contains no concept of "comity" for foreign regulation of non-U.S. advisers or non-U.S. funds. Moreover, it will be interesting to observe whether the vigorous opposition by many in the alternative fund industry to the proposed European Commission Directive on Alternative Investment Fund Managers will be mirrored in the United States.

The extent to which this legislation would lead to substantive regulation of hedge funds and other private funds (rather than their advisers) is unclear. Significantly, the Registration Act does not require the registration of the funds themselves; however, in testimony on July 15, Andrew Donohue, Director of the SEC's Division of Investment Management, suggested that fund registration is still under consideration. The proposed legislation, coupled with other legislative initiatives emerging from the Obama Administration, may have significant future implications for private funds and their advisers.

REGISTRATION

Currently, most private fund advisers rely on the exemption from Advisers Act registration available to advisers that have fewer than 15 clients. The Registration Act would eliminate this exemption. In effect, therefore, any investment adviser based in the United States that has more than $30 million under management would be required to register with the SEC. (U.S. advisers below this threshold would be required to register with the state in which they have their principal office and place of business.) Investment advisers based outside of the United States that manage private funds with U.S. investors and that do not fall within the proposed exemption for Foreign Private Advisers described below also would be required to register.

The Registration Act would also narrow the exemption that is currently available for fund advisers registered with the Commodity Futures Trading Commission ("CFTC") as a commodity trading adviser. Currently, such an adviser is exempt from Advisers Act registration if, among other things, its business does not consist primarily of providing investment advice with respect to securities. This exemption would no longer be available for an adviser to a "private fund", *i.e.*, a fund that would, in the absence of an exemption, be an investment company.

"Foreign Private Advisers" would be exempt from registration. The Registration Act defines a Foreign Private Adviser as an investment adviser who (i) has no place of business in the United States; (ii) during the preceding 12 months has had fewer than 15 clients in the United States; and (iii) has assets under management attributable to clients in the United States of less than $25 million or such higher amount as the SEC determines. This three-part test would have the effect of subjecting to Advisers Act registration any non-U.S. adviser to a private fund that has raised a minimal amount of capital from U.S. investors.

The legislation would also provide the SEC with the authority to define technical and other terms, including the term "client," in different ways for different classes of advisers. For example, although a private fund is counted as one client under current law, the SEC could define the term "client" for purposes of the Advisers Act anti-fraud rules to include investors in private funds.

ENHANCED DISCLOSURES – TO REGULATORS AND INVESTORS

The Registration Act would authorize the SEC to require registered investment advisers that manage "private funds" to maintain and submit (generally on a confidential basis) a broad range of records and reports concerning the private funds. The required private fund records would be subject to SEC examination. For purposes of this provision, a private fund is any fund that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the exemptions relied on by substantially all private funds) and either (i) is organized under United States law or (ii) has 10% or more of its outstanding securities owned by U.S. persons. The latter part of this definition could bring numerous foreign funds within the scope of the reporting provisions.

The legislation contemplates that the SEC will require the new reports to contain such information as the SEC determines is "necessary and appropriate in the public interest and for the assessment of systemic risk" by the Federal Reserve and the proposed Financial Services Oversight Council (the "Council"). The Council is the new federal inter-agency group proposed in the White Paper that would be chaired by the Secretary of the Treasury and whose members would include the chairs of the SEC, the CFTC and other financial regulatory agencies.

The information contained in these reports could include the private fund's:

- assets under management;
- use of leverage;
- counterparty credit risk exposure; and
- trading and investment positions and practices.

The information required to be reported could also include such other data as the SEC, after consultation with the Federal Reserve, determines is necessary in the public interest or to permit an assessment of systemic risk. The legislation also proposes that the SEC would, in conjunction with the CFTC, promulgate rules for establishing the form and content of such reports within six months after the law's enactment.

The reports would be shared with the Federal Reserve and the Council, presumably for purposes of identifying which, if any, private funds would be considered to be so large, so leveraged and so interconnected with other firms as to present significant risks to the financial system. It is possible that this may subject the largest private funds or groups of related funds to supervision and regulation as Tier 1 Financial Holding Companies, as proposed in the

White Paper. This would require such funds, among other things, to comply with more stringent capital, liquidity and risk management rules. The Administration has not yet proposed draft legislation that defines the scope of, and regulatory requirements to be applicable to, Tier 1 Financial Holding Companies.

Even though the Registration Act contemplates that the reports filed with the SEC and shared with the Federal Reserve and the Council will remain confidential, the Registration Act contains provisions that suggest that much of the information contained in these reports could be made public. The SEC would be authorized to require a registered investment adviser to provide reports, records and other documents to "investors, prospective investors, counterparties, and creditors" of any private fund. The standard for disclosure would be whether it is "appropriate in the public interest and for the protection of investors or for the assessment of systemic risk." This provision is novel in that it would allow the SEC to focus on systemic risk in addition to investor protection in designing public disclosure documents. It remains to be seen how the SEC will use this new authority.

The Registration Act would also repeal Section 210(c) of the Advisers Act, which generally prohibits the SEC from requiring a registered investment adviser to disclose the identity, investments or affairs of any client. While this change may have been designed to eliminate an impediment to the private fund reporting provision, it may have broader implications.

THE BIGGER PICTURE: COMPANION INITIATIVES

The Registration Act should not be viewed in isolation and is one of many initiatives that may impose more substantive regulation on private fund advisers. For example, on July 10, the Administration released draft legislation – the Investor Protection Act of 2009 – that would increase the SEC's rulemaking authority with respect to investment advisers and broker-dealers.

The Investor Protection Act would empower the SEC to promulgate rules to establish that persons who are providing investment advice about securities will "act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser." The Investor Protection Act also directs the SEC to examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest and compensation schemes for financial intermediaries (including broker-dealers and investment advisers) that are deemed to be "contrary to the public interest and the interests of investors."

Although the Investor Protection Act appears to focus on advisory services provided to retail customers or clients, it may allow the SEC to include other customers and clients (potentially private funds) within the new rules it promulgates. Further, while the Administration has not suggested that the review of compensation arrangements is aimed at private fund fee arrangements, or that private fund advisers would be viewed as "financial intermediaries," the Investor Protection Act does not specifically exclude them.

* * *

It remains to be seen what shape the proposed legislation and other initiatives will take in Congress in the weeks and months ahead. Vigorous debate and private fund industry opposition to certain of the provisions in the Registration Act can be expected. We plan to monitor future developments in this area and will report on any important developments.

Please feel free to contact us with any questions.

New York

Michael P. Harrell
+1 212 909 6349
mpharrell@debevoise.com

Paul L. Lee
+1 212 909 6955
pllee@debevoise.com

Byungkwon Lim
+1 212 909 6571
blim@debevoise.com

Washington, D.C.

Kenneth J. Berman
+1 202 383 8050
kjberman@debevoise.com

Frankfurt

Marcia L. MacHarg
+49 69 2097 5120
mlmachar@debevoise.com