

June 19, 2009

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## PRESIDENT OBAMA'S REGULATORY REFORM PROPOSAL TARGETS ALL PRIVATE INVESTMENT FUNDS

Private investment fund professionals have long been anticipating changes in how their industry will be regulated. Proposed legislation in Congress this year has ranged from requiring private investment funds to register under the Investment Company Act of 1940 (the Investment Company Act) to requiring the funds' managers to register as investment advisers under the Investment Advisers Act of 1940 (the Advisers Act)<sup>1</sup>. It now appears that some combination of both is likely, with President Barack Obama releasing his long-awaited proposal (the Reform Proposal) for regulatory reform of the U.S. financial system.

Issued on June 17, 2009, the 88-page Reform Proposal's recommendations for regulating private investment funds is a combination of new approaches and previously failed attempts to require either the funds and/or their management firms to register in some fashion with the Securities and Exchange Commission (the SEC). As discussed below, while the Reform Proposal, like recently introduced legislation, seems aimed at hedge funds, it will probably have a more significant impact on managers of traditional private equity and venture capital funds.

### Investment Adviser Registration of Fund Managers

The Reform Proposal would require managers of hedge funds, private equity funds, venture capital funds and other private pools of capital to register as investment advisers with the SEC. Funds with a "modest threshold" of assets under management, likely in the \$30 million to \$50 million range if the recent legislative proposals are any indication, would not have to register. The Reform Proposal does not give guidance on whether the registration requirement would extend to "fundless sponsors," firms without committed capital who raise funds for buyout or other investment activities.

The Reform Proposal basically re-introduces a prior SEC rule (vacated by a federal court in 2006 for being arbitrary) that required hedge fund managers to register as investment advisers. While the short-lived SEC rule did not apply to funds that required two-year capital lock-ups (essentially a carve out of customary private equity and venture capital funds) the Reform Proposal applies to all private investment funds.

The wider sweep of the Reform Proposal compared to the vacated SEC rule is consistent with legislation currently pending in Congress, as well as the positions Treasury Secretary Timothy Geithner and SEC Chair Mary Shapiro have taken in their numerous testimonies before Congress this year.

### Information Reporting Requirements

The Reform Proposal stops short of recommending that the funds register under the Investment Company Act, as some pending legislation would require. But it would institute certain reporting and operational requirements on all funds managed by SEC-registered advisers, essentially incorporating the intended result of pending legislation to obtain information on how private investment funds operate and whether they pose risk to the financial system.

<sup>1</sup> For example, the Hedge Fund Transparency Act of 2009 introduced in the U.S. Senate and the Hedge Fund Advisers Registration Act of 2009 introduced in the U.S. House of Representatives.

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Funds would therefore be subject to requirements relating to (a) recordkeeping; (b) disclosures to investors, creditors and counterparties; and (c) regulatory reporting requirements including, on a confidential basis, the amount of assets under management, borrowings, off-balance sheet exposures and “other information necessary to assess whether the fund or fund family is so large, highly leveraged, or interconnected that it poses a threat to financial stability.” The Reform Proposal also states that the SEC should share these reports with the Federal Reserve. This information is less intrusive than what other pending legislation would require. That said, the Reform Proposal recommends that “[t]he SEC should conduct regular, periodic examinations of such funds to monitor compliance with these requirements.”

## Implications

The Reform Proposal is long on generalities and extremely short on specifics. It will now take on a life of its own in Congress. There is no way to predict what ultimately will survive the upcoming political process. Nonetheless, we believe some predictions can be made since the proposal does combine many elements of pending legislation and SEC recommendations that the financial industry has been bracing to reluctantly accept as a new reality. In that regard, it appears increasingly likely that legislation will be enacted as early as this fall that requires private investment fund managers to register as investment advisers. The SEC has long been seeking regulatory authority to open the hood to see how these funds actually operate. The goal—be it wise or misguided—is to use what is learned to both reduce investor risk and limit the ability of funds to introduce systemic risk into the financial markets.

The sole exemption to registration will be for “smaller” funds. Neither the Reform Proposal, nor any of the proposed legislation, exempts certain types of funds like traditional private equity or venture capital funds that buy and hold private company securities until those companies are sold, registered on the public markets or have some other “exit”.

What does it mean for fund managers to be regulated as investment advisers? All advisers (even those not registered with the SEC) are subject to the anti-fraud and anti-manipulation provisions of the Advisers Act. In addition, some of the compliance requirements for registered advisers include the following:

- filing with the SEC Form ADV Part I and distributing to clients Form ADV Part II, which requires detailed disclosures of fund activities such as information about the manager’s businesses, affiliates and owners, their disciplinary history, and disclosures about certain conflicts of interest
- keeping certain books and records
- rules governing custody of clients’ securities and funds
- disclosure of regulatory and administrative actions
- adopting and complying with a compliance manual and code of ethics that subject advisers to extensive policies and procedures on their internal controls
- designating a chief compliance officer
- periodic and ongoing SEC examinations
- satisfaction of fiduciary duties to clients
- detailed rules on the use of prior performance in promoting a new fund to prospective investors
- restrictions on performance-based compensation (e.g., carried interest or incentive allocations)<sup>2</sup>

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<sup>2</sup> Registered investment advisers may receive performance-based compensation only from “qualified clients,” basically those that have a net worth of at least \$1.5 million or have at least \$750,000 of assets under management with the adviser.

It is also not clear that a federal registration exemption based on low amounts of assets under management will prevent a state securities administrator from recognizing that exemption. For example, hedge fund managers who are not registered with the SEC due to an existing registration exemption for advisers with five or fewer clients (where a fund is treated for this purpose as one client) are required to register in states that do not have similar exemptions. That is why many hedge fund managers are already registered as investment advisers with the SEC or a state counterpart. Most of these managers are located outside of New York and the handful of other states that do not have registration exemptions available for fund managers managing a de minimis number of funds. Accordingly, if all private investment fund managers are considered to be investment advisers under federal law, states may follow suit and require that the managers who qualify for the federal exemption register with the state.

There could even be a silver-lining for investors in private investment funds, especially smaller funds or those who have investments with different fund managers, who would arguably have access to better and more consistent information.

While the Reform Proposal is just that, a proposal that will be worked over heavily in Congress, the private investment fund universe appears to be headed for a new alignment in which managers of all funds (be they venture capital, leverage buy-out, or hedge) will be regulated as investment advisers.

Cognizant of the inevitability of registration, the Private Equity Council (the PEC), a D.C.-based advocacy communication and research organization, issued a statement the same day<sup>3</sup> that gave a backhanded endorsement of the Reform Proposal while observing that, “we and most experts agree that private equity firms do not create systematic risk . . .” With the PEC counting as members industry giants such as Apax Partners; Apollo Global Management LLC; Bain Capital Partners; The Blackstone Group; The Carlyle Group; Hellman and Friedman LLC; Kohlberg Kravis Roberts & Co.; Madison Dearborn Partners; Permira; Providence Equity Partners; Silver Lake; and TPG Capital, it is unlikely a serious countervailing voice will arise from the private equity community, at least, to challenge the Reform Proposal.

Meanwhile, the National Venture Capital Association has taken a somewhat different approach, challenging the sweeping breadth of the Reform Proposal even though many venture capital funds may avoid being swept up into the new regulatory oversight scheme.<sup>4</sup>

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<sup>3</sup> Private Equity Council Press Release, dated June 17, 2009, *Private Equity Council Issues Statement on Administration’s Financial Regulatory Proposal* (attributable to Douglas Lowenstein, President of the Private Equity Council).

<sup>4</sup> National Venture Capital Association Press Release, dated June 17, 2009, *Venture Capital Industry Does Not Pose Systematic Risk to Financial Stability* (attributable to Jennifer Connell Dowling, Vice President of Federal Policy for the NVCA).

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