



Regulation and Registration of Private Equity/Venture Capital Fund Advisers

Introduction

On June 17, 2009, the Department of Treasury released a White Paper on Financial Regulatory Reform (the “White Paper”), which proposed that advisers to private pools of capital register with the Securities and Exchange Commission (the “SEC”) under the Investment Advisers Act of 1940, as amended (the “Advisers Act”). The Advisers Act was enacted to regulate the actions of investment advisers by requiring registration with the SEC. However, many Private Equity/Venture Capital (“PE/VC”) fund sponsors currently avoid registration by relying on exemptions in the Advisers Act.

On July 15, 2009, the Department of Treasury delivered to Congress draft legislation, entitled the Private Fund Investment Advisers Registration Act of 2009 (the “Investment Advisers Registration Act”), to implement enhanced investment adviser registration under the Advisers Act, as highlighted in the White Paper. The draft legislation has not yet been formally introduced in Congress but it is anticipated that Congress will introduce and move forward with this legislation, or other similar legislation relating to the registration of fund advisers, when it reconvenes in September 2009.

Many smaller and mid-size PE/VC fund sponsors currently rely on the “private adviser” exemption under the Advisers Act to avoid registration with the SEC. The “private adviser” exemption currently exempts from registration any investment adviser that:

- has fewer than 15 clients; and
- does not hold itself out to the public as an investment adviser or act as an investment adviser to any registered investment company or business development company.

This exemption has traditionally been interpreted so that a fund counts as one “client” regardless of its size and many sponsors of PE/VC funds have relied upon this exemption to avoid registration with the SEC.

The Investment Advisers Registration Act would effectively eliminate the private adviser exemption and require all investment advisers, including PE/VC fund sponsors, with any office in the U.S. and more than \$30 million in assets under management, to register with the SEC under the Advisers Act. On June 16, 2009, Senator Jack Reed introduced a similar bill, titled the Private Funds Transparency Act of 2009 (the “Private Funds Transparency Act”), which would also eliminate the private adviser exemption available under the Advisers Act and replace it with a limited exemption from registration only for a limited number of foreign private advisers. Both bills are designed to increase the ability of regulators to monitor private fund activity and to assess whether such funds and their activities pose any systemic risk by requiring disclosure of private investment fund

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information through the adviser, rather than by the fund itself.

Registration Requirements

Under the Investment Advisers Registration Act, the requirement to register with the SEC would apply to all investment advisers (including PE/VC fund sponsors) to any “private fund.” A “private fund” is defined as a company that:

- would be an investment company (*i.e.*, any entity investing primarily in securities) under the Investment Company Act of 1940, as amended (the “Investment Company Act”), but for the exceptions contained in Section 3(c)(1) or Section 3(c)(7), (*i.e.*, exceptions for funds with less than 100 investors or investors that are all “qualified purchasers,” which are the exemptions currently relied on by almost all PE/VC funds); and
- is either organized in or created under the laws of the United States or that has 10 percent or more of its outstanding securities owned by U.S. persons.

Under the Private Funds Transparency Act, the current “private adviser” exemption would also be eliminated. Both bills would retain a limited private adviser exemption for “foreign private advisers.” To qualify as a “foreign private adviser,” an adviser must:

- have no place of business in the United States;
- have fewer than 15 clients in the United States; and
- manage less than \$25 million in assets attributable to clients in the United States and not hold itself out to the public in the U.S. as an investment adviser.

Collection of Data, Records and Reports

Investment advisers that are currently required to register with the SEC must file a Form ADV and keep it current by filing periodic amendments, including an annual amendment on Schedule I to Form ADV. Part I of Form ADV requires investment advisers to provide information about their business activities, assets under management and financial industry affiliations, among other things. Part II of Form ADV requires disclosure of the background and business practices of the investment adviser and can be given to clients of the investment adviser to comply with the “brochure rule,” which requires that certain information about the adviser be provided to clients and prospective clients. It is unclear whether the registration of investment advisers would still occur on Form ADV under any of the legislative proposals and whether Form ADV would be modified.

Once registered with the SEC, a PE/VC fund sponsor would be subject to the general provisions under the Advisers Act, including that it must:

- adopt compliance policies and procedures and maintain books and records;
- make and maintain filings with the SEC;
- maintain records and make them available to the SEC upon request; and
- comply with other rules covering fund audits, advisory agreements, fees, documentation, disclosure and custody rules.

PE/VC fund sponsors registered with the SEC would also be subject to periodic SEC audits as well as periodic, special or other examinations by the SEC.

In addition to the current disclosure requirements under the Advisers Act, the Investment Advisers Registration Act and the Private Fund Transparency Act would authorize the SEC to require PE/VC fund sponsors to maintain records and submit reports about the PE/VC funds under advisement that are determined to be “necessary or appropriate” in the public interest for the protection of investors or for the assessment of systemic risk. The Private Fund Transparency Act is silent as to which governmental body would make such a determination, while the Investment Advisers Registration Act identifies the Board of Governors of the Federal Reserve System (the “Board”) and the Financial Services Oversight Council (the “Council”) as responsible for monitoring and assessing systemic risk. The reports provided to the Board and/or the Council would not be publicly available documents. Under the Investment Advisers Registration Act, a PE/VC fund sponsor would have to make a report with respect to each private fund it advises, disclosing:

- the fund’s assets under management;
- use of leverage (including off-balance sheet leverage);
- counterparty credit risk exposure;
- trading and investment positions and trading practices; and
- other information that the SEC, in consultation with the Board, determines necessary or appropriate.

The Investment Advisers Registration Act would also require the SEC to share with the Board and the Council all records and reports filed by advisers that the Board or the Council considers necessary for the purpose of assessing the systemic risk of a fund or assessing whether a fund should be designated as a Tier 1 financial holding company, which would subject the fund to more rigorous

¹ The White Paper and subsequent Treasury Department proposed legislation on systemic risk do not provide a bright-line test to determine whether a financial company is a Tier 1 financial holding company. Under the systemic risk legislative proposal, the Board may designate a financial company as a Tier 1 financial holding company if it determines that material financial distress at the company could pose a threat to the financial stability of the United States or the global or United States economy based on several enumerated considerations.

federal scrutiny.¹ The SEC is supposed to keep confidential any information in reports that would be filed with the SEC under the Investment Advisers Registration Act, except pursuant to requests from Congress or other federal agencies. However, the Investment Advisers Registration Act would also authorize the SEC to require investment advisers to provide reports, records, and other fund documents to investors, prospective investors, counterparties, and creditors, which could have implications relating to the disclosure of proprietary information and competitive advantages.

Both the Investment Advisers Registration Act and the Private Fund Transparency Act would give the SEC extremely broad rulemaking authority to define terms used in the Advisers Act, including the ability to ascribe different meanings to terms (including the term “client”) used in different sections of the Advisers Act as the SEC determines necessary to effect the purposes of the Advisers Act. In short, these provisions could permit the SEC to craft different rules governing advisers to differing types of private investment funds (*i.e.*, hedge funds, private equity funds and venture capital funds).

Conclusions

- The Investment Advisers Registration Act and the Private Fund Transparency Act would effectively eliminate the private adviser exemption under the Advisers Act and require essentially all PE/VC fund sponsors to register with the SEC.
- While there is some uncertainty as to the final content of the legislation, if any, that may be enacted, it appears increasingly likely that sponsors of PE/VC funds will be required to register under the Advisers Act.
- Any enacted legislation would likely:
 - require fund sponsors to file with the SEC additional substantive information regarding each individual fund they advise, in addition to the current disclosure requirements under the Advisers Act; and
 - authorize the SEC to require fund advisers to share information disclosed to the SEC with investors, prospective investors, counterparties and creditors.
- Registration in accordance with the current provisions of the Advisers Act should be manageable for most PE/VC fund sponsors. However, the additional burden on PE/VC fund sponsors that would result from the enhanced disclosure requirements contained in the legislative proposals remains uncertain. Many PE/VC fund sponsors are already registered, even some which are otherwise eligible for an exemption, in order to attain favorable status under ERISA for corporate pension plan investors or for enhanced credibility and favorable fundraising with certain large investors. The real impact of this legislation is the opening of the regulatory door to further reporting and requirements for PE/VC fund sponsors down the road.
- The White Paper emphasized the role highly leveraged hedge funds played in the financial crisis and stated that registration of these types of funds would allow regulators to monitor their market activity. However, the current regulatory efforts are overbroad in that they do not distinguish between the types of hedge funds that may pose risks to the financial markets and PE/VC funds that raise similar concerns, nor is any distinction made between smaller/mid-sized funds and large, highly leveraged funds.
- The Investment Advisers Registration Act and the Private Fund Transparency Act appear to mark a departure from the approach encompassed in the Hedge Fund Transparency Act of 2009, introduced by Senators Chuck Grassley and Carl Levin on January 27, 2009, which would require registration of private investment funds themselves under the Investment Company Act. This may suggest that the current preferred regulatory approach is not to require registration of funds themselves, but rather to require the disclosure of fund information indirectly through the advisers to such funds. However, some uncertainty exists as to the final outcome of the current legislative proposals and an alternative regulatory oversight approach may be adopted.

Given the likelihood that Congress will enact some form of legislation requiring the registration of PE/VC fund sponsors or PE/VC funds, currently unregistered PE/VC fund sponsors should analyze their supervisory systems and business practices in anticipation of the potential required registration with the SEC. We will continue monitoring the progress of the bills and other legislative and regulatory initiatives on PE/VC funds and their sponsors and will advise our clients and friends of such developments as they occur.

If you have any questions regarding the matters discussed in this client briefing, please contact any of the Winston & Strawn professionals listed below.

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