SIMPSON THACHER MEMORANDUM

Highlights of Obama Administration's Financial Regulatory Proposals Relevant to Private Funds and Their Advisers

June 26, 2009

INTRODUCTION

On June 17, 2009, in response to the ongoing global financial crisis and several high profile investment scandals, President Obama unveiled his administration's ambitious proposal for financial regulatory reform, titled "Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation" (the "Proposal"). The Proposal focuses on three major initiatives: (1) comprehensive federal supervision of systemically significant financial organizations, regardless of whether they are affiliated with a bank, and increased powers to regulate and resolve those organizations; (2) expanded supervision of financial markets, including the over-the-counter derivatives and securitization markets; and (3) consumer protection from unfair or inappropriate financial products. With respect to the regulation of private funds and their advisers, the Proposal sets forth several important recommendations, which, if implemented, would, among other things, require registration of most private fund advisers, impose largely unspecified disclosure and reporting obligations on private funds advised by such advisers and potentially subject private funds that are determined to be systemically significant to strict supervision by the Federal Reserve.

For an overview of the entire Proposal, including areas not covered by this memorandum, please refer to our recently published memorandum entitled "Treasury Department Outlines Reforms to U.S. Financial Supervision and Regulation," a copy of which is available at www.simpsonthacher.com/content/publications/pub838.pdf.

Registration of Private Fund Advisers

The Proposal calls for a requirement that all advisers to private funds, including private equity funds, hedge funds, and venture capital funds, whose assets under management exceed a "modest threshold", register with the SEC under the Investment Advisers Act of 1940. Under current regulations, many private fund advisers are exempted from registration with the SEC without regard to their assets under management, in reliance on the Advisers Act's "private adviser" exemption.[1] Notably, the Proposal defers the issue of determining the "modest

[1] Section 203(b)(3) of the Advisers Act provides an exemption for a "private adviser" that (i) has had fewer than fifteen clients during the preceding twelve months, (ii) does not hold itself out generally to the public as an investment adviser and (iii) does not act as an investment adviser to any registered investment company or business development company.

threshold" that will trigger the registration requirement, and this will certainly be a focal point as the Proposal progresses through the legislative process. Also unaddressed in the Proposal is the applicability of SEC registration to foreign investment advisers to private funds with U.S. investors.

Reporting and Disclosure Requirements of Private Funds Advised by Registered Advisers

The Proposal also calls for the imposition of certain requirements on the private funds advised by registered advisers, including recordkeeping, disclosures to investors, creditors, and counterparties and regulatory reporting. Such regulatory reporting would be made to the SEC on a confidential basis and would include assets under management, borrowing, off-balance sheet exposure, and other information necessary for the SEC to determine whether the fund or fund family is so large, leveraged or interconnected as to pose a threat to financial stability if it were to fail. The Proposal provides that the SEC would be authorized to audit the books of such private funds regularly and periodically to monitor their compliance with these requirements, although it is unclear whether this inspection would be part of, or in addition to, SEC inspections of registered advisers. The Proposal acknowledges that these requirements may vary across the different types of private funds and therefore, private equity funds and venture capital funds that are not highly leveraged and that have minimal exposure to derivative transactions may be subject to reporting requirements that are less stringent that those applicable to hedge funds, although a concern exists as to the application of these reporting requirements to information concerning portfolio companies. The Proposal addresses a key concern that a fund's confidential and proprietary information not be publicly disclosed, although we note that under current law, any information filed with the SEC could be subject to public disclosure under the Freedom of Information Act ("FOIA") unless the staff grants a filer's request for confidential treatment of such information. Moreover, the proposed mandatory disclosure to investors, creditors and counterparties is described in very broad terms and questions remain, including, for example, which counterparties and creditors this requirement would apply to and the types of information and level of detail that would be subject to disclosure. While it remains possible that such reporting and disclosure requirements will not differ significantly from those currently applicable to registered advisers, it is difficult at this time to gauge the true burden of compliance with these newly-proposed obligations.

Regulation of Private Funds as Tier 1 FHCs

One of the most significant changes contemplated by the Proposal is the imposition of comprehensive regulation by the Federal Reserve on any firm "whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed." The Proposal calls for the Federal Reserve, in consultation with the Treasury Department, to identify these firms, which are referred to as "Tier 1 Financial Holding Companies" or "Tier 1 FHCs", which may be designated as such regardless of whether they own or control banks or other depository institutions and which may include private funds. All financial firms categorized as

Tier 1 FHCs would be subject to the supervision and regulation of the Federal Reserve. To account for the greater risks that their potential failure would impose on the financial system, Tier 1 FHCs would be subject to stricter capital, liquidity, and risk management standards, enhanced public disclosure, assessments of capital and liquidity adequacy under severe stress scenarios, a prompt corrective action regime similar to the regime for insured depository institutions and restrictions on non-financial activities. In addition, Treasury proposes the creation of a new resolution regime to allow for the orderly resolution of failing bank holding companies and other Tier 1 FHCs in situations where the stability of the financial system is at risk. As noted above, the Proposal would require private funds advised by registered advisers to disclose certain information to the SEC, which would in turn be shared with the Federal Reserve, so that it can determine whether any such fund or fund family meets the criteria that would require it to be regulated as a Tier 1 FHC. Although this aspect of the Proposal relating to Tier 1 FHCs is mostly directed at firms like AIG that got into trouble with its exposure to credit default swaps, some private funds or fund sponsors may potentially be subject to categorization as Tier 1 FHCs as well. Becoming subject to regulation and supervision of the Federal Reserve would likely be a matter of significance to a private fund sponsor regarding the overall conduct of its business.

Other Implications

The Proposal is wide ranging in scope and in addition to the topics described above, addresses the following items, which could affect the operations and investments of private funds:

- increased regulation of OTC derivatives and derivative dealers;
- harmonization of securities and futures regulations by the SEC and CFTC;
- strengthening of consumer and investor protection, including aligning the duties of registered advisers and broker-dealers by establishing a fiduciary duty for broker-dealers that offer investment advice, and expanding regulations applicable to registered advisers and broker-dealers with respect to conflicts of interest;
- creation of a Financial Services Oversight Council, chaired by the Treasury Secretary and with members of seven other federal banking and financial markets agencies, which would identify systemic risks and improve interagency cooperation;
- strengthening regulation of the securitization markets, by requiring sponsors to have "skin in the game," restricting compensation arrangements and increasing transparency and standardization of securitization reporting and disclosure;
- enhancement of oversight of, and disclosure by, the credit rating agencies; and
- strengthening of restrictions on transactions between banks and their affiliates, including private funds managed or sponsored by such banks.

As noted previously, these items, as well as other aspects of the Proposal not covered by this memorandum, are discussed in more detail in our recently published memorandum referenced above and available at www.simpsonthacher.com/content/publications/pub838.pdf.

Conclusion

The Proposal sets out an ambitious agenda. It leaves many details to be worked out through the legislative and rule-making process, and it is likely that certain elements of the Proposal will not survive. However, given the current economic and political environment, we believe it is likely that some form of regulation requiring private fund adviser registration and enhanced disclosure and reporting by private funds will be implemented. This is further supported by the spate of recent legislative proposals focusing on the regulation of private funds and advisers, including Senator Reed's recently proposed, "Private Fund Transparency Act", Senators Levin and Grassley's "Hedge Fund Transparency Act," and Congressmen Capuano and Castle's "Hedge Fund Adviser Registration Act." In addition, the Proposal is part of a concerted global effort to regulate private pools of capital, as reflected in the declaration by G-20 leaders regarding the regulation of hedge funds and the European Commission's proposed directive on alternative investment fund managers. We will continue to monitor the progress of the Proposal and the other regulatory developments that would affect private fund advisers and their funds.

This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as memoranda regarding recent corporate reporting and governance developments, can be obtained from our website, www.simpsonthacher.com.

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