June 30, 2010

House-Senate Conference Committee Approves Private Fund Investment Advisers Registration Act

On June 25, 2010, a House-Senate conference committee reached final agreement on the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). Included in Title IV of the Act is the Private Fund Investment Advisers Registration Act of 2010, which eliminates the "private adviser exemption" from SEC registration currently contained in Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Advisers Act") for investment advisers who do not hold themselves out to the public as investment advisers and have fewer than 15 clients. As a result, many investment advisers to private funds (with some exceptions) will be required to register with the SEC. Importantly, the conference committee agreed to delete a provision in the Senate's version of the bill that would have exempted "private equity fund" advisers from registration with the SEC. Registered advisers will be subject to substantial regulatory reporting and recordkeeping requirements regarding the private funds they advise. In addition, the Act effectively raises the assets under management ("AUM") threshold for federal registration of investment advisers to $100 million, with those advisers falling below such threshold becoming subject to state registration and regulation. Title IV becomes effective one year after the date of enactment (presumably July 2011), during which time the SEC is expected to adopt rules and regulations providing procedures for registration and reporting. Investment advisers to private funds may voluntarily register with the SEC during this one-year period.

SEC Registration Requirement

Upon the elimination of the "private adviser exemption," many investment advisers to private funds will be required to register with the SEC. Additionally, the Act defines a "private fund" as any issuer that would be an investment company under Section 3 of the Investment Company Act of 1940 (the "Investment Company Act"), but for the exception provided by either Section 3(c)(1) or Section 3(c)(7) thereunder. Most private investment funds commonly rely on these provisions of the Investment Company Act to avoid regulation as an investment company.

Exemptions from SEC Registration

The Act provides the following exemptions from SEC registration as an investment adviser:

- an adviser that solely advises private funds and has aggregate AUM in the United States of less than $150 million (such an adviser is nevertheless subject to certain recordkeeping and reporting requirements described below);

- an adviser that solely advises "venture capital funds" (to be defined by the SEC) (such an adviser is nevertheless subject to certain recordkeeping and reporting requirements described below);

- an adviser that is a "foreign private adviser" which is defined as an adviser that: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser; (iii) has aggregate AUM attributable to clients and investors in the United States in private funds advised by such adviser of less than $25 million; and (iv) neither holds itself out generally to the public in the United States as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act or any business development company;

- an adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor and advises a private fund (however, if the "business of the advisor should become predominately the provision of securities-related advice," then such adviser must register with the SEC);

- an adviser to small business investment companies, which are regulated by the Small Business Administration; and

- family offices (to be defined by the SEC in a manner consistent with the SEC's prior exemptive orders and certain grandfathering provisions); the Act excludes family offices from the definition of "investment adviser" under Section 202(a)(11) of the Advisers Act, effectively placing such entities outside the purview of the Advisers Act (except that family offices that rely on the grandfathering provisions are subject to the antifraud provisions of Section 206(1), (2) and (3)).

In addition, with respect to "mid-sized private funds" (as yet not defined), the SEC must provide for registration and examination procedures that reflect the level of systemic risk posed by such funds taking into account the size, governance and investment strategy of such funds.

Records; Reports; Examinations

The SEC is given general authority to require recordkeeping and reporting by registered investment advisers and to conduct periodic examinations of such advisers. The records of any private fund advised by an SEC-registered adviser are "deemed to be the records and reports of the investment adviser." SEC-registered advisers to private funds are required to maintain records regarding each private fund they advise, including a description of the following: amount of AUM; use of leverage; counterparty credit risk exposures; trading and investment positions; valuation policies and practices of the fund; types of assets held; side arrangements or side letters; trading practices; and other information relevant to determining potential systemic risk. Such records are subject to periodic, special or other examinations by the SEC at any time. Registered advisers will also be subject to ongoing periodic reporting requirements, which could be expanded beyond the current requirements under Form ADV.

Importantly, advisers that are exempt from registration with the SEC because they either solely advise venture capital funds or solely advise private funds and have AUM in the United States of less than $150 million are subject to such recordkeeping and reporting requirements as the SEC "determines necessary or appropriate in the public interest or for the protection of investors."

Information Sharing; Disclosures

Reports filed with the SEC by such advisers are not subject to disclosure pursuant to Freedom of Information Act requests. The SEC will report annually to Congress on how the SEC uses the data collected to monitor the markets for the protection of investors and the integrity of the markets. The SEC will share with the Financial Stability Oversight Council (the "Council") such reports and other documents provided to it by registered advisers as the Council considers necessary for the purposes of assessing the systemic risk of private funds. Confidentiality protection is provided for any proprietary information submitted to the government, including sensitive, non-public information regarding the investment adviser's investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property. Regarding disclosure, Section 210(c) of the Advisers Act is amended to permit the SEC to require an investment adviser to disclose the identity, investments or affairs of any client "for purposes of assessment of potential systemic risk."

Limitation on SEC Rulemaking Authority

For purposes of the first two subparagraphs of the antifraud provisions of Section 206 of the Advisers Act, the Act prohibits the SEC from defining the term "client" to include an investor in a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser. As a result, it will continue to be the case that an investment adviser will owe a fiduciary duty to a private fund.

Asset Threshold for Federal Registration of Investment Advisers

The Act effectively raises the AUM threshold for federal registration of investment advisers from $25 million to $100 million. Any investment adviser that qualifies to register with its home state and has AUM between $25 million and $100 million (and that otherwise would be required to register with the SEC) must register with, and be subject to examination by, such state. If the investment adviser's home state does not perform examinations, the adviser is required to register with the SEC. In addition, if any investment adviser would be required to register with 15 or more states, it may register with the SEC.

Custody

The Act requires a registered adviser to take steps to safeguard client assets over which it has custody as the SEC may prescribe, including, verification of such assets by an

independent public accountant. Within three years after the enactment of the Act, the U.S. Government Accountability Office ("GAO") must submit a report to Congress on the compliance costs associated with the current SEC custody rule applicable to registered investment advisers.

Accredited Investor Standard

The SEC is required to modify the "accredited investor" net worth standard applicable to a natural person to provide that the value of a person's primary residence shall be excluded from the calculation of the $1 million net worth requirement. The SEC is required to review and modify such definition periodically. Within three years after the enactment of the Act, the GAO must submit a report to Congress on the appropriate criteria for accredited investor status and eligibility to invest in private funds.

Qualified Client Standard

Within one year after the date of enactment (and periodically thereafter), the SEC is required to adjust for inflation the net worth and/or asset-based qualifications applicable to a "qualified client" under the Advisers Act. Under current law, an SEC-registered adviser may only charge incentive or performance based fees to investors in a fund if they meet the qualified client standard set forth in Rule 205-3 of the Advisers Act.

SRO for Private Funds

Within one year after the enactment of the Act, the GAO must submit a report to Congress on the feasibility of forming a self-regulatory organization ("SRO") to oversee private funds.

Other Relevant Provisions

- *Enhancing investment adviser examinations.* Pursuant to Section 914, the SEC must review and analyze the need for enhanced examination and enforcement resources for investment advisers, including consideration as to whether designating one or more SROs to augment the SEC's efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers.

- *Investor access to information on registered investment advisers.* Pursuant to Section 919B of the Act, the SEC is required to complete a study on ways to improve the access of investors to registration information about registered investment advisers, including disciplinary actions, regulatory, judicial and arbitration proceedings.

- *Reg D offerings.* Section 926 of the Act amends certain provisions of the Securities Act applicable to private offerings made in reliance on the safe harbor set forth in Rule 506 of Regulation D of the Securities Act. The Act requires the SEC to issue

rules disqualifying an offering or sale of securities as a Regulation D offering where the person offering the securities: (i) is subject to a final order by a state securities, banking or insurance authority, a federal banking agency or the National Credit Union Administration that (a) bars the person from (1) association with any entity regulated by such authority, (2) engaging in the business of securities, insurance or banking, or (3) engaging in savings association or credit union activities, or (b) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct within the 10-year period ending on the date of the filing of the Form D; or (ii) has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum may be directed to:

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