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investment management alert

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Implications of the Private Fund Investment Advisers Registration Act of 2010 for Hedge Fund and Private Equity Fund Managers

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Title IV of the Dodd-Frank Act, titled the Private Fund Investment Advisers Registration Act of 2010 (the "Registration Act") significantly modifies the registration and reporting requirements under the Investment Advisers Act of 1940, as amended (the "Advisers Act") by, as more fully discussed below, eliminating the "private adviser exemption" historically relied upon by most U.S. domiciled and offshore hedge fund and private equity fund advisers to avoid registration under the Advisers Act and replacing it with a limited foreign private adviser exemption. The Registration Act also eliminates a private fund adviser's ability to assert the intrastate exemption from registration, narrows the exemption for commodity trading advisers, directs the SEC to create an exemption for advisers with assets under management of less than $150 million who provide advice solely to private investment funds, revises the definition of "accredited investor" and excepts "family offices" from the definition of "investment adviser."

Elimination of the Private Adviser Exemption for U.S. Domiciled Private Fund Advisers

Prior to the Registration Act, Section 203(b)(3) of the Advisers Act exempted from registration any investment adviser that (i) had fewer than 15 clients during the preceding twelve month period (ii) was not an investment adviser to a registered investment company or a business development company as defined in the Investment Company Act of 1940, as amended (the "ICA") and (iii) did not hold itself out as an "investment adviser" to the public (the "private adviser exemption"). Whether one is holding itself out to the public is a factual inquiry and the SEC has on numerous occasions provided guidance as to what might be considered "holding out" to the public[1]. Because each private fund itself was deemed the "client" of the adviser for purposes of counting to 15 (and not fund investors), most hedge and private equity fund advisers asserted the private adviser exemption from registration. The Registration Act eliminates this exemption for U.S. domiciled advisers, but preserves certain aspects of the exemption for "foreign private advisers."

A "foreign private adviser" is defined by the Registration Act to mean an investment adviser that:

- has no place of business in the United States;
- has, in total, fewer than 15 clients **and investors** (emphasis added) in the United States in private funds[2] advised by the investment adviser;
- has aggregate assets under management of less than $25 million attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser (or such higher amount as the SEC may by rule deem appropriate); and
- does not hold itself out generally to the public in the U.S. as an investment adviser or act as an adviser to any registered investment company or business development company as defined under the ICA.

The foreign private adviser exemption provides some relief for offshore managers, but it is narrowed by the requirement to count "investors" of private funds and by the $25 million assets under management threshold. These conditions will compromise the ability of certain foreign advisers to assert this exemption where they manage U.S. domiciled vehicles, large separate accounts, and where ERISA and other U.S. tax-exempt investors invest in offshore private funds.

The Registration Act also includes the following exemptions from registration under the Advisers Act:

Exemption and Reporting By Certain Private Fund Advisers With Less Than $150 Million of Assets Under Management. The SEC is directed to exempt from registration certain investment advisers that exclusively provide advice to private funds and have assets under management of less than $150 million. The SEC may prescribe that such advisers maintain certain books and records and provide the SEC with annual and other reports, as it deems necessary and appropriate and in the public interest or for the protection of investors.

- In light of the exclusivity requirement, investment managers who advise separate accounts, even if just one, may not assert this avenue for exemption. This issue is particularly relevant to fund managers who have been, or are considering, being seeded by an institution or high net worth investor in a separate account or who otherwise might consider providing advice to clients through a separate account.
- In determining the amount of "assets under management," the entire value of the securities portfolios for which the adviser provides continuous and regular supervisory or management services is to be included (including the value of securities purchased on margin)[3].

Registration and Examination of Mid-Sized Private Fund Advisers. Without defining the term "mid-sized private fund," the Registration Act directs the SEC to consider the size, governance, and investment strategy of such funds to determine whether they pose systemic risk, and to provide for registration and examination procedures with respect to advisers of such funds that are consistent with the level of systemic risk posed by such funds.

Certain Mid-Sized Investment Advisers. The Advisers Act currently prohibits an investment adviser from registering with the SEC if the adviser's assets under management are less than $25 million, provided such adviser is regulated or required to be regulated in the state in which it maintains its principal place of business. When assets under management are between $25 million and $30 million[4], registration with the SEC is permissible, but not required. Once assets under management equal or exceed $30 million, registration with the SEC is required unless an exemption from registration can be asserted. The Registration Act has created a second category that generally prohibits registration with the SEC by "mid-size investment managers," which are managers with assets under management between $25 million and $100 million that (i) do not advise a registered investment company or business development company and (ii) are required to be registered (as opposed to simply being "regulated") as an investment adviser with the securities commission (or agency or office performing like functions) of the state in which it maintains its principal place of business and subject to examination by any such commissioner, agency, or office.

- "Mid-size" hedge fund and private equity fund managers with at least one separate account[5] that fall under state *de minimus* exemptions generally will not benefit from this expanded prohibition from registration.
    - To see how this works, the initial inquiry is whether or not the adviser is required to be registered with the state securities commissioner in the state where it maintains its principal office. If the answer to this query is "no," then the adviser is not prohibited from registering with the SEC and, in fact, will be required to register with the SEC once its assets under management equal $30 million unless a separate exemption can be asserted. As previously discussed, the Registration Act now eliminates the ability of U.S. domiciled advisers to assert the "private adviser exemption." The Registration Act also carves out private fund advisers from the intrastate exemption under Section 203(b)(1) of the Advisers Act (which could not previously have been asserted by managers that traded equities in any event)[6].
- If a "mid-size" investment manager is required to register with fifteen or more states, then such manager may register with the SEC.

Advisers to "Venture Capital Funds." The Registration Act provides an exemption from registration to an investment adviser that advises solely one or more venture capital funds, but does contemplate that such advisers will be subject to certain books and records requirements and annual and other reporting requirements, as determined by the SEC. The Registration Act directs the SEC to define "venture capital fund" within one year of the date of the Registration Act's enactment.

- Advisers with multiple investment strategies who manage funds other than venture capital funds and separate accounts will not be able to take advantage of this exemption.
- What might the definition of "venture capital fund" look like? While clearly not binding on the SEC, by way of example, the State of California currently exempts certain advisers who provide advice to venture capital companies. Pursuant to California Administrative Code, title 10 §260.204.9(b)(3), an entity is a "venture capital company" if on at least one occasion during the annual period commencing with the date of its initial capitalization, and on at least one occasion during each annual period thereafter, at least fifty percent (50%) of its assets (other than short-term investments pending long-term commitment of distribution to investors), valued at cost, are venture capital investments or derivative investments. A "venture capital investment" is an acquisition of securities in an operating company as to which the investment adviser, the entity advised by the investment adviser, or an affiliated person of either has or obtains management rights[7]. The California Administrative Code defines "management rights" to mean the right, obtained contractually or through ownership of securities, either through one person alone or in conjunction with one or more persons acting together or through an affiliated person, to substantially participate in, to substantially influence the conduct of, or to provide (or to offer to provide) significant guidance and counsel concerning, the management, operations or business objectives of the operating company in which the venture capital investment is made.

Impact on Commodity Trading Advisers. Investment Advisers registered with the Commodity Futures

Trading Commission (the “CFTC”) are currently exempted from registering as an investment adviser with the SEC under Section 203(b)(6) of the Advisers Act. The Registration Act limits this exemption by requiring a private fund adviser registered with the CFTC to also register with the SEC if the business of such adviser should become predominantly securities-related advice. Presumably changes to such manager's management of the private fund may implicate registration as well as an expansion of its overall business model to include securities-related advice, whether to other funds and/or to separate accounts.

Single Family Offices. The Registration Act excepts “family offices” from the definition of “investment adviser” under Section 202(a)(11) of the Advisers Act. In connection with its efforts to define “family office,” Congress has directed the SEC to provide an exemption that, among other things, is consistent with the SEC's previous exemptive policy, as reflected in exemptive orders previously given by the SEC to family offices, and that recognizes the range of organizational, management, and employment structures and arrangements employed by family offices.

Additional Recordkeeping and Reporting Requirements

In addition to existing recordkeeping and reporting requirements, the Registration Act requires registered advisers to maintain the following minimum books and records with respect to each private fund advised by the investment adviser: (i) the amount of assets under management and use of leverage, including off-balance sheet leverage; (ii) counterparty credit risk exposure; (iii) trading and investment positions; (iv) valuation policies and practices of the fund; (v) types of assets held; (vi) side arrangements or side letters; (vii) trading practices; and (viii) such other information as the SEC, together with the Financial Stability Oversight Council, determine is appropriate and necessary in the public interest and for the protection of investors or for the assessment of systemic risk. Different reporting requirements may apply to different classes of advisers based on the type and size of private fund being advised.

Adjustments to the Definition of “Accredited Investor;” Review Documentation and Distribution Relationships

The Registration Act revises the definition of “accredited investor” set forth in Regulation D of the Securities Act of 1933, as amended. Generally speaking, individual investors have been able to qualify as an accredited investor pursuant to either an “annual income test” or “net worth test.” Prior to enactment, an individual was able to satisfy the “net worth test” if the net worth of such individual, or joint net worth with such person's spouse, at the time of purchase, was more than $1,000,000. The Registration Act makes it more difficult to meet the net worth test by excluding the value of the primary residence of such natural person. This exclusion is effective immediately (e.g., July 21, 2010) and the SEC is directed to conduct subsequent reviews of the entire definition of “accredited investor” as such term applies to natural persons beginning no earlier than 4 years after enactment of the Registration Act and occurring no less frequently than once every 4 years thereafter to determine if adjustments or modifications should be made.

- Since the standard is determined *at the time of purchase*, existing funds will not have to recertify their existing investors as to their accredited investor status, unless and until such investors make additional contributions. Funds must, however, ensure that new investors meet this revised standard.
- In the interim, however, we recommend that funds review their existing offering documents to ensure that, where discussed, the definition of “accredited investor” accurately reflects the revised standard.
- Advisers with distribution and solicitation agreements should also review these agreements to determine whether any specific investor standards are set forth that may need to be amended. Those advisers that rely upon third party placement agents for investor seasoning and qualification should discuss these revisions with their distributors to ensure that appropriate revisions are made by such placement agents.
- Financial service organizations and other third party distributors should review their internal training materials and supervisory procedures to ensure that appropriate revisions are made.
- Congress has directed the GAO to conduct a study on the appropriate criteria for determining financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds and to submit a report within 3 years.

Increase in Qualified Client Standard

With respect to the dollar thresholds used in determining a “qualified client” for purposes of Section 205 (e) of the Advisers Act (which relates to the ability of an investment adviser to charge a performance based fee), the Registration Act requires the SEC, no later than one year after the date of the enactment and every five years thereafter, to adjust the threshold to give effect to inflation (rounding up to the nearest multiple of $100,000 as necessary).

Investment managers that are impacted by the Registration Act will have one year from the date of enactment to register and comply with the substantive recordkeeping and other requirements of the Advisers Act. If you have any questions concerning this alert or require assistance in preparing for registration, please contact the Venable attorneys in our Investment Management Practice Group or our Corporate Finance and Securities Group.

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(1) See *Statement of The Commission Regarding Use of Internet Web Sites To Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore*, Securities Act Release No. 33-7516, 1998 WL 128173 (Mar. 23, 1998); Lamp Technologies, Inc., SEC No-Action Letter, 1997 WL 282988 (May 29, 1997); *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*; Securities Act Release No. 33-7288 (May 9, 1996); *Status of Investment Advisory Programs Under the Investment Company Act of 1940*, Investment Company Act Release No. 21260 n.8, 1995 WL 447507, *17 (July 27, 1995); Resource Bank and Trust, SEC No-Action Letter, 1991 WL 178723 (Mar. 29, 1991); Richard W. Blanz, SEC No-Action Letter, 1985 WL 52006 (Jan. 28, 1985) Dale M. Muller, SEC No-Action Letter, 1994 WL 44944 (Feb. 20, 1984); Weiss, Barton Asset Management, SEC No-Action Letter (Mar. 12, 1981); Peter H. Jacobs, SEC No-Action Letter, 1979 WL 13879 (Feb. 7, 1979).

(2) "Private Fund" is defined by the Registration Act as any issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, as amended, but for section 3(c)(1) and 3(c)(7) under the Investment Company Act. This definition will implicate most hedge funds and private equity funds.

(3) Item 5.F of the Instructions to Part I of Form ADV.

(4) Advisers Act § 203A-1.

(5) Advisers with assets under management of less than $150 million that provide advice exclusively to private funds may fall under the new exemption to be provided by the SEC.

(6) As a result of the Registration Act, Section 203(b)(1) may be asserted by advisers other than private fund advisers, all of whose clients are residents of the same state within which the adviser maintains its principal office and place of business and who do not provide advice about securities listed or admitted to unlisted trading privileges on any national securities exchange.

(7) Cal. Admin. Code, title 10 §260.204.9(b)(4).

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