

To: Our Clients and Friends

July 29, 2010

Private Fund Investment Advisers Registration Act of 2010: New Law Changes Regulatory Framework for Alternative Investment Managers

On July 21, 2010, President Obama signed into law the financial reform package known as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which contains the Private Fund Investment Advisers Registration Act of 2010 (the "Private Fund Act"). The Private Fund Act changes the regulatory framework that governs investment advisers managing private fund investments, including private equity funds, hedge funds and certain real estate funds. Specifically, the Private Fund Act (i) requires that many investment advisers, including certain foreign investment advisers, that are currently exempt from registration with the Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), register with the SEC; (ii) requires that certain investment advisers currently registered with the SEC change to state registration and (iii) significantly expands the reporting and recordkeeping requirements for domestic and foreign investment advisers to private funds of all types. The Private Fund Act adopts a new set of limited exemptions from SEC registration based on the asset class managed, the amount of assets under management and/or the operational details of foreign managers. At the same time, the Private Fund Act significantly expands the reporting and recordkeeping requirements to which these exempt entities will be subject going forward.

The Private Fund Act becomes effective one year from the date of the Dodd-Frank Act's enactment, on July 21, 2011. During this one year window, each affected investment adviser will need to become fully compliant with the requirements of the Private Fund Act, including SEC registration (which currently unregistered investment advisers may choose to pursue immediately). Although the Private Fund Act contemplates substantial SEC rulemaking and guidance over the next year, it is clear that investment advisers will need to devote substantial resources to comply with the Private Fund Act (including, for example, designation and training of a Chief Compliance Officer, adoption of extensive compliance procedures as mandated by the Advisers Act, and modification or adoption of SEC mandated internal reporting and recordkeeping systems).

Given the extensive work that many investment advisers will have to undertake in order to fully comply with the Private Fund Act (a process that can stretch into many months), we urge all Firm clients and

contacts to promptly begin considering what impact the Private Fund Act will have on their operations while developing a plan to comply with its various aspects. To assist our clients and contacts in determining whether you will be affected in this area, below is a brief summary of the changes resulting from the Private Fund Act.

Elimination of Pre-Private Fund Act Exemption and New Asset Level Thresholds For Registration

Under applicable securities laws, investment advisers are defined as persons or entities who provide advice to others about investments for a fee. Such individuals or entities are required to be registered as investment advisers on a federal or state level absent an exemption. Historically, alternative investment advisers have relied on what came to be known as the "private adviser" exemption to avoid SEC registration (Section 203(b)(3) of the Advisers Act). This exemption holds that an investment adviser that (i) has fewer than 15 clients in any 12-month period or whose clients are all located in the investment adviser's home state, (ii) is not an investment adviser to a registered investment company (e.g., mutual fund) or a business development company and (iii) does not hold itself out as an "investment adviser" to the public, is exempt from registration under the Advisers Act.

Under the "private adviser" exemption, the definition of "client" includes private investment funds that are exempt from registration as an investment company under the Investment Company Act of 1940, as amended (the "Investment Company Act"). These alternative investment private funds are typically structured as Section 3(c)(7) ("qualified purchaser") and Section 3(c)(1) ("accredited investor") private funds. Thus, a private equity or hedge fund manager could typically avoid SEC registration by ensuring that it had no more than 15 "private fund" clients even though it might have hundreds of institutional investors in its private funds and manage billions of dollars.

Further, in order for an investment adviser to register with the SEC under prior law, an investment adviser was required to manage a minimum of \$25 million assets under management at the time of SEC registration or within 12 months of registration. If an adviser had less than \$25 million in assets under management, it typically was required to register in the state where its home office resides and state(s) where its clients live absent a state exemption from registration.

A key feature of the Private Fund Act is the elimination of the "private adviser" exemption to SEC registration one year from the Dodd-Frank Act's enactment. All investment advisers must be in full compliance with the Private Fund Act's registration and reporting requirements at that date, absent another exemption. The net effect of this critical regulatory development is that it will trigger widespread federal or state registration by investment advisers that can no longer rely on this exemption. Furthermore, in an effort to focus SEC resources on larger investment advisers, the Private Fund Act increases the threshold amount of assets under management that a manager will be required to have for SEC registration (generally, a \$150 million minimum in assets under management for advisers solely advising private funds and a \$100 million minimum in assets under management for advisers that provide investment advice to clients, including but not limited to, private funds (e.g., separate accounts)). It shifts the regulatory oversight of smaller managers (i.e., managers with \$25 - \$100/\$150 million in assets under management) to the states. This will result in many currently SEC registered investment advisers having to deregister at the federal level and, instead, register with the applicable state regulators, a burdensome and costly process.

As noted above, the "private advisers" exemption will be eliminated and the minimum assets under management that will be required for an investment adviser to register with the SEC will be raised to \$100 million. Specifically:

- The Private Fund Act eliminates the current registration exemption for investment advisers with fewer than 15 clients (unless it can rely on another exemption) and replaces it with a limited exemption for certain "foreign private advisers" (as described below).
- The Private Fund Act eliminates the current registration exemption for investment advisers whose clients are all located in the investment adviser's home state.
- The Private Fund Act provides that an investment adviser with assets under management of over \$25 million will be required to register with the SEC unless it is a "Mid-Sized Investment Adviser" that can register with a state or can rely on another exemption. A "Mid-Sized Investment Adviser" is an investment adviser with assets under management between \$25 million and \$100 million (or such higher amount as determined in the future by the SEC) that is required to be registered in the state in which it maintains its principal office and place of business and, if registered, would be subject to examination with such state. A "Mid-Sized Investment Adviser" that is currently registered with the SEC under the Advisers Act is therefore required to deregister from the SEC and register with its applicable state regulators. To the extent a "Mid-Sized Investment Adviser" is not permitted to register with a state (e.g., state lacks investment adviser registration statute) or it is required to register in 15 or more states, SEC registration is still required. The shift in regulatory oversight from federal to state jurisdiction will be significant for most investment advisers falling into this category. Among other things, investment adviser principals that register with certain states may be required to pass FINRA examinations.

The exemptions from SEC registration that will be available following the enactment of the Private Fund Act include:

- Private Fund Adviser Exemption - The Private Fund Act includes a registration exemption for an investment adviser that acts solely as an adviser to private funds (i.e., funds that rely upon the exclusion from the definition of investment company provided in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act), with U.S. assets under management of less than \$150 million. To the extent an investment adviser also acts as an adviser to a separate account or managed account in addition to any private fund, this exemption will not be available. These exempt advisers must, however, maintain such records and provide the SEC with such annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors in its rulemaking process.

- Venture Capital Fund Adviser Exemption - The Private Fund Act includes a registration exemption for an investment adviser that serves as an adviser solely to one or more "venture capital funds" (to be defined by the SEC). Venture capital firms however, must maintain such records and provide the SEC with such annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors in its rulemaking process.
- Foreign Private Fund Advisers - The Private Fund Act includes a limited registration exemption for a "foreign private adviser," which is an investment adviser that: (i) has no place of business in the U.S., (ii) has fewer than 15 clients and investors in the U.S. in private funds that it advises, (iii) has less than \$25 million in assets under management attributable to clients in the U.S. and investors in the U.S. in the private funds that it advises and (iv) does not hold itself out to the public in the U.S. as an investment adviser or advise an investment company that is registered under the Investment Company Act or a business development company. This exemption represents a significant restriction to most foreign investment advisers that have relied on the current law to avoid registration.
- Family Office Exemption - The Private Fund Act excludes from the definition of investment adviser a "family office" (to be defined by the SEC).
- Registered Commodity Trading Adviser - The Private Fund Act provides a registration exemption for an investment adviser that is registered as a commodity trading adviser with the Commodities Futures Trading Commission (the "CFTC") and advises a private fund, provided that the investment adviser's business is not predominantly the provision of securities-related advice. To the extent that an investment adviser subsequently engaged in securities-related advice, such exemption is not available.

New Reporting Requirements

In addition to the extensive compliance and recordkeeping requirements that the Advisers Act requires of registered investment advisers (described below), the Private Fund Act provides that the SEC may now require a registered or unregistered investment adviser to maintain certain records and file reports regarding the private funds that it advises as the SEC deems necessary and appropriate in the public interest and for the protection of investors. The Private Fund Act allows the SEC to consider the specific type or size of the fund advised when crafting such rules, and the requirements may vary from fund to fund. In the case of large investment advisers, this includes an assessment of a manager's or fund's systemic risk to the financial system. The Private Fund Act permits the SEC to refer certain large funds to the newly established Financial Stability Oversight Council to designate for Federal Reserve systematic risk regulation. In furtherance of this goal, the SEC under the Private Fund Act is permitted to examine all records and books of private funds managed by an investment adviser, not simply those required by the Advisers Act (see next sections).

Under the Private Fund Act, registered and unregistered investment advisers will be required to maintain certain records and reports, including, for each private fund it advises, information regarding:

- Amount of assets under management
- Counterparty credit risk exposures
- Trading and investment positions
- Trading practices
- Use of leverage
- Valuation policies and practices
- Types of assets held
- Side arrangements or side letters
- Other information the SEC deems necessary

Compliance Manuals for Registered Investment Advisers

It should be noted that, in addition to the registration process itself, all SEC registered investment advisers are required, among other things, to adopt and implement extensive written policies and procedures (collectively, a "Compliance Manual") under the Advisers Act by which all investment adviser personnel must abide to ensure adequate regulatory compliance. A Compliance Manual is comprised of numerous policies mandated by the SEC to ensure that a registered investment adviser's management prevent, detect, and report violations of regulatory laws, including the following:

- Policy Regarding Compliance Monitoring
- Policy Regarding Advertising and Marketing
- Policy Regarding Solicitation Arrangements
- Policy Regarding Private Placement of Securities
- Policy Regarding Account Documentation and Accuracy of Disclosure
- Policy Regarding Anti-Money Laundering
- Policy Regarding Safeguarding Client Assets
- Policy Regarding Recordkeeping
- Code of Ethics
- Policy Regarding Insider Trading
- Policy Regarding Portfolio Management and Trading

- Policy Regarding Best Execution and Soft Dollars
- Policy Regarding Valuation
- Policy Regarding SEC Filings and Reporting
- Policy Regarding Privacy
- Policy Regarding Proxy Voting
- Policy Regarding ERISA Compliance
- Policy Regarding Business Continuity

Government Enforcement and Private Litigation Implications of the Dodd-Frank Act

We will address government enforcement and private litigation implications of the Dodd-Frank Act in forthcoming articles. For present purposes, advisers to private funds should be aware of the following potential landmines crafted into the legislation:

- Enhancements to whistleblower incentives and protections, which may encourage employees to report borderline (or even non-existent) issues to authorities.
- The lowering of the standard for "aiding and abetting" liability from "knowing and substantial" assistance to "knowing or reckless and substantial" assistance, which may encourage the SEC to pursue marginal actions against advisers or individuals who potentially may have assisted a violation.
- The mandating of more rigorous deadlines for the completion of enforcement actions, which may cause the SEC Staff to be even less flexible than currently in accommodating reasonable scheduling requests. The more rigorous deadlines may also cause the Staff to be less willing to give thoughtful, measured consideration to a potential defendant's/respondent's arguments.
- Enhancements to federal sentencing guidelines in matters involving financial fraud and the extension of the federal statute of limitations for securities actions (including actions by the SEC seeking monetary penalties) from 5 to 6 years.

As is true of other aspects of the Dodd-Frank Act, the broad parameters of the enforcement and litigation provisions will be sharpened by subsequent agency rulemaking. In addition, from an enforcement perspective, the discretion with which the SEC staff and other prosecutors deploy the tools now available will largely determine the legislation's true impact.

Other Changes of Significance to Investment Advisers

Finally, it should be noted that there are other provisions of the Dodd-Frank Act not discussed at length in this article that amend the Advisers Act and other federal securities laws in a manner that will be of significance to investment advisers. For example:

- The Dodd-Frank Act provides the SEC with additional authority to define terms used in the Advisers Act.
- The Dodd-Frank Act modifies the definition of "accredited investor" in Regulation D under the Securities Act of 1933, as amended (the "Securities Act"), to exclude, for purposes of determining whether the individual meets the \$1 million net worth accredited investor standard, an individual's primary residence. In addition, the SEC is required to adjust the accredited investor net worth standard to be more than \$1 million four years after enactment of the Dodd-Frank Act, and to review the entire accredited investor standard for natural persons no earlier than four years after enactment of the Dodd-Frank Act and then every four years thereafter.
- The SEC is directed to adjust for inflation the "qualified client" standard of Rule 205-3 under the Advisers Act (governing payment of performance fees to registered investment advisers) within one year after enactment of the Dodd-Frank Act and every five years thereafter.
- The Dodd-Frank Act expands the anti-fraud authority of the SEC and the US federal courts over conduct occurring outside of the United States.
- The Dodd-Frank Act requires that the SEC adopt rules to disqualify certain "bad actors" from relying on Regulation D under the Securities Act.
- Under the Dodd-Frank Act, a money manager that is an affiliate of a bank or a bank holding company will be subject to the "Volcker Rule," which prohibits a money manager from engaging in proprietary trading or investing in or sponsoring private funds, subject to certain exceptions.
- The Dodd-Frank Act includes new regulation of over-the-counter derivatives and persons that engage in such transactions. These provisions could require certain entities that are counterparties to swaps (including a private fund that engages in swap transactions) to register with the SEC or the CFTC, and would subject these entities to clearing, margin and trading requirements when engaging in certain over-the-counter derivative transactions.

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As noted above, we believe that substantial resources will be allocated over the next year by clients and contacts who will need legal advice and assistance on federal and state registration issues, reporting and recordkeeping requirements and adoption of a Compliance Manual. Our team has extensive experience in this area, having successfully shepherded investment advisers' registrations on both federal and state levels, drafted and implemented Compliance Manuals and other policies and procedures and advised clients with respect to compliance audits and other actions brought by regulatory authorities.

To discuss these issues further, please feel free to contact any of the Bryan Cave attorneys listed below:

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