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Significant New Registration, Reporting and Regulatory Requirements Imposed on Advisers to Private Funds

On July 21, 2010, President Obama officially signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**"), which represents the most sweeping regulatory overhaul of the financial markets since the Great Depression. Title IV of the Act, codified as the Private Fund Investment Advisers Registration Act of 2010 (the "**Registration Act**"), contains amendments to the Investment Advisers Act of 1940 (the "**Advisers Act**") and certain other statutes that will impose more stringent registration, reporting and other regulatory requirements on investment advisers that provide advice to one or more "private funds" (defined as entities that would be required to register as investment companies under the Investment Company Act of 1940 ("**Company Act**") but for an exemption provided under Sections 3(c)(1) or 3(c)(7) of the Company Act). Set forth below is a summary of certain key provisions of the Registration Act.

Repeal of the Private Adviser Exemption

The Advisers Act currently exempts any investment adviser, such as an investment fund manager, from registration with the Securities and Exchange Commission ("**SEC**") under the Advisers Act if that adviser: (i) has fewer than 15 clients during the preceding 12 months; (ii) does not advise any registered investment companies; and (iii) does not hold itself out generally to the public as an investment adviser (the "**Private Adviser Exemption**"). Since each private fund generally counts as one client for purposes of the Private Adviser Exemption, advisers can manage up to 14 investment funds with hundreds of investors and hundreds of millions in assets without having to register as an investment adviser with the SEC. The Registration Act repeals the Private Adviser Exemption and replaces it with several much more limited exemptions from registration, which are described in more detail below. As a result, many private fund managers (including many private equity fund managers) will, absent the availability of an exemption, be required to register with the SEC (or applicable state regulatory authorities) and comply with various recordkeeping, reporting and other requirements.

Exemptions and Prohibitions from Registration

In place of the Private Adviser Exemption, the Registration Act contains a number of significant, but much more limited exemptions from registration:

- **Foreign Private Adviser Exemption.** The Registration Act provides an exemption from registration under the Advisers Act for "foreign private advisers" (the "**Foreign Adviser Exemption**"). A "foreign private adviser" is defined under the Registration Act as an investment adviser that: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 U.S. clients and investors in private funds advised by such adviser; (iii) has less than an aggregate of \$25 million in assets that are attributable to U.S. clients and investors in private funds advised by such adviser; (iv) does not hold itself out to the public as an investment adviser in

the United States; and (v) does not advise any registered investment companies or business development companies. The Foreign Adviser Exemption is extremely narrow and will likely require further clarification and guidance from the SEC. Due to the extremely limited nature of the Foreign Adviser Exemption, the Registration Act, as it currently stands, may ultimately require many non-U.S. advisers either to significantly curtail their U.S. operations or register with the SEC.

- **Venture Capital Exemption.** The Registration Act provides an exemption from registration for advisers that provide advice *solely* to one or more “venture capital funds” (the “**Venture Capital Exemption**”). The term “venture capital funds” is not defined in the Registration Act. Instead, the SEC is directed to issue final rules defining the term “venture capital funds” no later than one year after the enactment of the Registration Act. Accordingly, the details of the Venture Capital Exemption will develop over the next year as the SEC begins the rulemaking process. The usefulness and availability of the Venture Capital Exemption will depend almost entirely on how the SEC determines to define “venture capital funds.” Advisers qualifying for the Venture Capital Exemption will be required to maintain such records and provide such annual or other reports as the SEC determines to be necessary or appropriate for investor protection or in the public interest.
- **Family Office Exemption.** Consistent with current law, advisers to “family offices” are excluded from the definition of investment adviser under the Advisers Act and, therefore, will not be required to register with the SEC. As with the Venture Capital Exemption, the Registration Act does not purport to define the term “family office,” leaving the definition and most of the details of the exemption to later SEC rulemaking. Nevertheless, the Registration Act requires that the family office exemption:
 - be consistent with prior exemptive positions taken by the SEC; and
 - recognize the range of organizational, management and employment structures and arrangements employed by family offices.

Assuming that the SEC defines family office in a manner consistent with its prior exemptive orders in this area, the family office exemption will likely be limited to single family offices serving lineal descendants of a single individual, their spouses and entities and charities owned by, for the benefit of, or created by, such individuals. Persons qualifying for the family office exemption will remain subject to the anti-fraud provisions of the Advisers Act.

- **Private Fund Exemption.** The SEC is required to adopt an exemption from registration for any adviser that:
 - has assets under management in the United States of less than \$150 million; and
 - provides investment advice *solely* to one or more private funds (the “**Private Fund Exemption**”).

Importantly, the Private Fund Exemption will not be available to advisers that provide advice to any clients other than private funds (*i.e.*, the exemption will not be available to advisers providing advice to *both* private funds and

separately managed accounts). Even if exempt from registration, advisers qualifying for the Private Fund Exemption will be required to maintain such records and provide such annual or other reports as the SEC determines to be necessary or appropriate for investor protection or in the public interest. In developing such recordkeeping and reporting requirements, the SEC is required to take into account fund size, governance, investment strategy and level of systemic risk posed by the private funds advised by such advisers. Accordingly, it is likely that the requirements applicable to many funds, such as private equity and real estate funds, will be less onerous than the requirements applicable to traditional hedge funds. The Private Fund Exemption will not be available until the SEC promulgates rules providing for the exemption.

- **Advisers Prohibited from Registering with the SEC.** Under current law, advisers must generally have at least \$25 million in assets under management in order to be eligible to register with the SEC. The Registration Act significantly alters the current regulatory framework by generally prohibiting an adviser from registering with the SEC if the adviser: (i) has between \$25 million and \$100 million in assets under management (or such higher dollar amounts as the SEC may decide by rule); (ii) is registered, or required to be registered, as an investment adviser with the state in which it maintains its principal office and place of business; and (iii) is or would be subject to examination as an investment adviser by such state. Notwithstanding the foregoing, an adviser not otherwise permitted to register with the SEC may register if that adviser: (i) has at least \$25 million in assets under management; and (ii) would, as a result of the prohibition from SEC registration described above, be required to register as an investment adviser with 15 or more state regulatory authorities. As with the current law, advisers to registered investment companies or business development companies must register with the SEC regardless of their assets under management. As a result of this provision, many small and mid-sized advisers with less than \$100 million in assets under management will be required to register with one or more states instead of the SEC. It is unclear at this time whether advisers currently registered with the SEC (or advisers otherwise registered with the SEC prior to the effectiveness of the Registration Act) will be grandfathered in such that they can maintain their current registrations with the SEC, even if such advisers do not meet the increased threshold described above. If no grandfathering rule is adopted, many small and mid-sized advisers will be forced to de-register with the SEC and register with one or more applicable states in which they conduct business.

While earlier versions of the Registration Act contained an exemption for advisers providing advice *solely* to one or more private equity funds, such exemption was not included in the final version of the Registration Act. Consequently, unless an exemption from registration is available, many private equity fund managers will be required to register with the SEC (or one or more state regulatory authorities). In addition, many states will begin to adopt amendments to their respective adviser registration statutes in response to the elimination of the Private Adviser Exemption and the various other provisions included in the Registration Act. In particular, states may begin to require all federally unregistered fund managers based in those states to become state-registered

advisers. Similar to the Registration Act, amendments to state investment adviser statutes could also impose more stringent recordkeeping and reporting requirements on advisers registered in those states.

Required Records and Reports

The Registration Act includes provisions that will significantly increase the recordkeeping and reporting requirements applicable to many private fund managers. Advisers will be required to maintain records and file reports with respect to private funds as the SEC deems necessary and appropriate in the public interest and for investor protection, or for the assessment of systemic risk by the Financial Stability Oversight Council (the "**Council**") created under Title I of the Act. The records and reports required to be maintained by a private fund manager must include, with respect to each private fund that it manages, a description of:

- The amount of assets under management and use of leverage, including off-balance-sheet leverage;
- Counterparty credit risk exposure;
- Trading and investment positions;
- Valuation policies and procedures;
- Types of assets held;
- Side arrangements or side letters whereby certain investors in a fund obtain more favorable rights or entitlements than other investors;
- Trading practices; and
- Such other information as the SEC, in consultation with the Council, determines to be necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

The Registration Act expressly authorizes the SEC to establish different sets of reporting requirements for different classes of fund advisers based on the type or size of private funds advised by such advisers. Consequently, the content, format and detail required with respect to the reporting requirements will be determined by, and will be subject to, future SEC rulemaking.

The Registration Act provides that the SEC generally may not be compelled to disclose any report or information contained therein required to be filed with it. Nevertheless, the SEC is required to:

- Make available to the Council copies of all reports, documents, records and information filed with or provided to it as the Council considers necessary for the purpose of assessing systemic risks posed by private funds;
- Provide information to Congress upon an agreement of confidentiality;

- Comply with a proper request for information from any other Federal department, agency or any self-regulatory organization; and
- Comply with court orders in cases brought by the United States or the SEC.

Moreover, the SEC is restricted from publicly disclosing any “proprietary information” that is obtained from any report, except in the case of a public hearing, a resolution or request from Congress or for purposes of assessing systemic risk. As used in the Registration Act, “proprietary information” is defined as sensitive, non-public information regarding: (i) the investment or trading strategies of the adviser; (ii) analytical or research methodologies; (iii) trading data; (iv) computer hardware or software containing intellectual property; and (v) any additional information that the SEC determines to be proprietary.

The Council and any department, agency or self-regulatory authority that receives reports or information from the SEC is required to maintain the confidentiality of such reports and information in a manner consistent with the level of confidentiality established by the SEC.

The Registration Act also authorizes the SEC to disclose the identity of an adviser’s clients for the purpose of assessing potential systemic risks as well as in connection with a proceeding or investigation relating to the enforcement of the Advisers Act.

Modifications to Accredited Investor Definition

The Registration Act directs the SEC to adjust the net worth standard for an accredited investor to require that the individual net worth of any natural person, or joint net worth with the spouse of that person, is, at the time of purchase, greater than \$1 million, exclusive of the value of the person’s primary residence (in contrast to the current requirement, which requires the same net worth but allows an investor to count the value of his or her primary residence). The change to the individual net worth standard is effective immediately upon enactment of the Registration Act and may not be altered by the SEC for four years after its enactment. Private fund managers should review and modify their existing offering documents and subscription materials as appropriate to account for the modifications to the accredited investor definition.

Beginning four years after the enactment of the Registration Act, the SEC is required, no less frequently than once every four years, to undertake a comprehensive review of the accredited investor definition to determine whether modifications to such definition are appropriate. Upon completion of its review, the SEC is authorized to make changes to the accredited investor definition, but only with respect to natural persons.

Modifications to Qualified Client Standard

The Advisers Act generally prohibits registered advisers – including advisers registered with state regulatory authorities – from charging performance or similar fees based upon a percentage of capital appreciation in a client’s account. Rule 205-3 under the Advisers Act provides an exemption from this performance fee prohibition

and permits advisers to charge performance fees to persons that qualify as “qualified clients.” “Qualified clients” are generally defined as natural persons or companies that have at least \$750,000 under management with the adviser or natural persons or companies that the adviser reasonably believes either have a net worth of more than \$1.5 million or are “qualified purchasers” under the Company Act. The Registration Act requires the SEC to adjust for inflation the dollar amount of the \$750,000 in assets under management and \$1.5 million net worth thresholds for determining a person’s status as a “qualified client” within one year after the enactment of the Registration Act and every five years thereafter. Any inflation adjustments must be made in multiples of \$100,000.

Other Significant Provisions

In addition to the foregoing, the Act also contains a number of other provisions that may impact advisers to private funds including, but not limited to, the following:

- **Volcker Rule.** Subject to certain exceptions, the Act amends the Bank Holding Company Act of 1956 to limit and restrict banks, bank holding companies and certain non-bank financial companies from investing in or sponsoring hedge funds and private equity funds. As a result of these restrictions, banking entities will be required to divest or substantially reduce their interests in hedge and private equity funds.
- **Reporting of Short Positions.** Pursuant to Title IX of the Act, the SEC is required to promulgate new rules requiring all Form 13F filers to disclose at least monthly the amount of their short sales in any security. The short sale reporting provisions will likely be similar in many respects to the Form SH reporting requirements that were imposed on Form 13F filers during 2008 and 2009. Title IX also makes manipulative short selling unlawful and directs the SEC to promulgate rules to address manipulative short selling.
- **Bad Actor Disqualification.** Within one year after the enactment of the Act, the SEC is required to issue rules to disqualify certain “bad actors” from using the exemptions available under Regulation D of the Securities Act to offer and sell securities.
- **Mandatory Arbitration.** Title IX of the Act gives the SEC broad authority to adopt rules and regulations restricting or prohibiting the use of mandatory arbitration agreements by advisers.

Transition Period

Except with respect to the change to the accredited investor standard, most of the provisions of the Registration Act will become effective in July 2011 (one year after its enactment). Notwithstanding the foregoing and subject to rules promulgated by the SEC, an investment adviser may voluntarily register with the SEC under the Advisers Act during the one-year transition period leading up to the effectiveness of the Registration Act.

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