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Changes to the U.S. Investment Advisers Act Affecting Non-U.S. Private Fund Advisers with Compliance Deadline of July 21, 2011

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The Private Fund Investment Advisers Registration Act of 2010: The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which was signed into law July 21, 2010, effects changes to the Investment Advisers Act of 1940 (the "Act") that increase the chances that non-U.S. private fund advisers who manage funds with U.S. investors will be subject to regulation by U.S. regulators. On November 19, 2010, the Securities and Exchange Commission ("SEC") proposed rules to implement these provisions of Dodd-Frank.[1]

What will change: Currently, advisers with fewer than 15 U.S. clients generally are exempt from registration under the Act.[2] Because advisers who manage U.S. private funds can count each fund as a single client, most private equity and hedge fund managers had been entitled to rely on this exemption. Dodd-Frank eliminates this so-called "private adviser exemption" and replaces it with several narrower exemptions, including (i) a **"foreign private adviser exemption,"** and (ii) an exemption for advisers with assets under management of less than $150 million who exclusively advise private funds (the **"private fund adviser"**).

Foreign Private Adviser Exemption

The foreign private adviser exemption exempts qualifying managers from SEC oversight completely-no registration is required and no reporting requirements or examination exposure apply. This exemption will only apply to an investment adviser that (i) has no place of business in the United States, (ii) has fewer than 15 clients and private fund[3] investors in the United States[4], (iii) has assets under management attributable to such clients and private fund investors of less than US$25 million (or such higher amount as determined by the SEC)[5], and (iv) neither holds itself out generally to the U.S. public as an investment adviser nor acts as an investment adviser to a registered investment company or business development company. (Note that

adoption of a new, low-dollar threshold of assets under management may capture non-U.S. advisers generally and not just advisers of private funds.)

Private Fund Adviser Exemption

If the non-U.S. adviser does not meet the foreign private adviser exemption, it may qualify instead for a partial exemption the SEC has proposed for advisers to "qualifying private funds," generally. The proposed rules would allow a non-U.S. adviser whose only U.S. clients are private funds and whose assets under management in those funds are less than $150 million to avoid registration. However, unlike the foreign private adviser exemption that is a complete exemption, under the proposed rules, the private fund adviser exemption is essentially a partial exemption, as advisers relying upon this exemption would still be subject to significant reporting requirements and SEC examinations, despite being exempt from registration.[7]

For this purpose, a non-U.S. adviser is one that maintains its principal office and place of business outside of the United States. Whether a client is a U.S. Person is determined with reference to the definition of "U.S. Person" in Regulation S under the Securities Act of 1933, such that off-shore funds will generally not be U.S. Person clients. In addition, such a non-U.S. adviser will count only assets managed by the adviser from a place of business in the United States.[8] To be clear, under the proposed rule, a non-U.S. adviser seeking to rely on the private fund adviser exemption would need only to count its private fund assets managed from a place of business in the United States toward the "less than $150 million" threshold. If no assets are managed from a place of business in the United States, the reporting and examination consequences of this exemption may still apply.

The reporting requirements would require these advisers to disclose certain identifying information, the exemption from registration relied on, other business activities, financial industry affiliations, information about private funds advised and the funds' service providers, identities of all control persons, and the disciplinary history of the adviser and its employees. As proposed, these disclosures would be made by the exempt advisers by completing substantial portions of Form ADV (the SEC's registration form for investment advisers), which would be publicly available through the SEC's Investment Adviser Registration Depository ("IARD").[9]

What this means to non-U.S. private fund managers

Non-U.S. advisers who meet the narrow terms of the foreign private adviser exemption will enjoy total exemption from the SEC's registration, reporting and examination requirements. Non-U.S. advisers who meet the more generous terms of the private fund adviser exemption will be exempt from registration, but will be subject to recordkeeping and reporting requirements and SEC examinations, if the Proposed Rules are adopted as proposed.

Non-U.S. advisers who don't meet the terms of the foreign private adviser exemption or the private fund adviser exemption will need to register by July 21, 2011 and take the following steps to comply with the requirements imposed on registered investment advisers:

- **Registration on Form ADV**-To register, advisers must complete Form ADV, which requires substantial disclosures to the SEC and to the adviser's clients. Form ADV must be updated at least annually and, with respect to certain key information, at the time of certain changes in the reported information.[10]

- **Disclosures to Adviser's Clients**-"Part 2" of Form ADV, or the "brochure," calls for substantial narrative description of the adviser's business, products, management, material adverse financial or disciplinary matters, conflicts of interest, and policies designed to address conflicts of interest.[11] Advisers are required to deliver their brochure to advisory clients annually. The brochure is often used as a means of conveying other required disclosures such as privacy policies. The Proposed Rules suggest that private fund advisers may have the option of not preparing Part 2, and advisers will likely weigh this option in light of investor expectations.

- **Adoption of a Comprehensive Compliance Program**-Registered advisers must adopt written policies and procedures designed to prevent violation of the Act and its rules. Such written policies must be reviewed at least annually for adequacy and effective implementation, and a chief compliance officer must be appointed to oversee their administration.[12]

- **Adoption of an Anti-Insider Trading Policy**-Registered advisers must have a policy designed to ensure that material, non-public information is not misused in violation of the Act or the U.S. Securities Exchange Act of 1934 (the "1934 Act"), and may entail (i) circulating a written policy to all employees, (ii) employee training programs, (iii)

creating physical and organizational information barriers, (iv) maintaining restricted lists, watch lists, and rumor lists, and/or (v) maintaining a procedure for monitoring client and personal trades.[13]

— **Adoption of Code of Ethics and Personal Trading Policy for Access Persons**-These policies are considered critical to managing conflicts of interest and other regulatory and fiduciary objectives. Access persons[14] must report their personal securities holdings and transactions. Some access persons must also obtain pre-clearance before participating in, and may be barred from investing in, initial public offerings and limited offerings.[15]

— **Subject to SEC Examination Authority**-The SEC conducts periodic examinations of registered advisers.[16] Registrants will benefit from staying abreast of "hot topics" and periodic SEC staff statements about the focus of the SEC's examination program.

— **Substantial Recordkeeping Obligations**-The Act imposes requirements with respect to adviser records substantiating the basis of performance claims and other records reflecting the relationship between the adviser and its clients. Certain private fund records must also be maintained. These records include AUM, the use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies, side arrangements or side letters, trading practices, and any other subjects deemed necessary for the public interest, investor protection, or the assessment of systemic risk.[17]

— **Compliance with Anti-Fraud Laws**[18]-The Act generally prohibits a wide range of fraudulent, deceptive and manipulative conduct, and conduct that has fraudulent, deceptive or manipulative results, whether intentional or not. Rules under the Act extend these protections to investors in the adviser's private funds. In addition to the anti-fraud provisions of the Act, advisers may be subject to the anti-fraud and manipulation provisions of the other federal securities laws, such as Section 17(a) of the U.S. Securities Act of 1933, as amended, and Rule 10b-5 under the Securities Exchange Act of 1934, as amended. (Note that these obligations apply to registered and unregistered advisers alike.)

— **Custody Rules**-The Act imposes specific measures registered advisers must take to safeguard client assets over which the adviser has, or is deemed to have, custody. These steps include maintenance of client assets with a "qualified custodian" and submission to an annual surprise examination by an independent public accounting firm (or the issuance of annual audited financial statements by private funds advised by the adviser).[19]

Reed Smith has a team of lawyers dedicated to helping our non-U.S. adviser clients analyze and apply the new and complex set of registration exemptions Dodd-Frank has brought upon us. For assistance in analyzing the effect of these changes on your advisory business, please contact the authors of this Alert or the Reed Smith lawyer with whom you regularly work.

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1. See Advisers Act Rel. No. 3111 (Nov. 19, 2010), available at www.sec.gov/rules/proposed/2010/ia-3111.pdf (the "Exemptions Release"), and Advisers Act Rel. No. 3110 (Nov. 19, 2010), available at www.sec.gov/rules/proposed/2010/ia-3110.pdf (the "Implementing Release"; the rules proposed under the Implementing Release and the Exemptions Release are collectively referred to herein as the "Proposed Rules").
   2. Section 203(b)(3) of the Act states that adviser registration requirements shall not apply to "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under title I of this Act, or a company which has elected to be a business development company pursuant to section 54 of title I of this Act and has not withdrawn its election. For purposes of determining the number of clients of an investment adviser under this paragraph, no shareholder, partner, or beneficial owner of a business development company, as defined in this title, shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner; ..."
   3. "Private funds" are defined to mean funds that meet the exemptions of Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act"). See

Section 202(a)(29) of the Act as amended by Dodd-Frank.

4. With respect to any client or investor, "in the U.S." is defined to mean a "U.S. Person" as defined in Section 902(k) of Regulation S of the Securities Act of 1933. See proposed Rule 202(a)(30)-1(c)(2) in the Exemptions Release. Additionally, see the Proposed Rules for guidance on client and investor counting, a discussion of which is beyond the scope of this bulletin.

5. The Proposed Rules fail to raise this $25 million threshold. See the Implementing Release for guidance on calculating assets under management.

6. The Exemptions Release defines "qualifying private fund" to mean a private fund that is not registered under Section 8 of the 1940 Act and is not a business development company under the 1940 Act.

7. See the Implementing Release for guidance on the reporting requirements and n. 113 of the Implementing Release, which states: "Under section 204(a) of the Advisers Act, the Commission has the authority to examine records, unless the adviser is 'specifically exempted' from the requirement to register pursuant to section 203(b) of the Advisers Act"-the private fund adviser exemption is pursuant to Section 203(m).

8. See Proposed Rule 203(m)-1 in the Exemptions Release. See also Implementing Release for guidance on calculating assets under management.

9. Note that the SEC has asked for comments on whether exempt advisers should have to complete the entire Form ADV. See the Implementing Release.

10. See Rule 203-1 of the Act.

11. See Rule 204-3(a) of the Act.

12. See Rule 206(4)-7 of the Act.

13. See Section 204A of the Act.

14. An "access person" is an adviser's employee who (i) has access to non-public information regarding any client's purchase or sale of securities, (ii) has access to non-public information regarding the portfolio holdings of any reportable fund, or (iii) is involved in making securities recommendations to clients, or who has access to such recommendations that are non-public. All officers, directors and partners of the adviser are presumed to be access persons. See Rule 204A-1(e)(1) of the Act.

15. See Rule 204A-1(c) of the Act.

16. As discussed supra, the Proposed Rules would extend this examination authority to include advisers exempt from registration in reliance on the private fund adviser exemption.

17. See Rule 204-2 of the Act. See also Advisers Act Rel. No. 3145 (Jan. 26, 2011) available at http://reedsmithupdate.com/ve/88B31u313071NxkE75/stype=click/OID=811210135621682/VT=0, which proposes Form PF for purposes of reporting on private funds advised by investment advisers registered with the SEC.

18. The anti-fraud laws actually generally apply to advisers and market participants whether registered or not, but registration increases visibility and opportunities for enforcement.

19. See Rule 206(4)-2 of the Act.