ALERTS AND UPDATES

U.S. Financial Reform: Registration of Advisors to Private Investment Funds and Pools, and of Small Advisory Firms

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act") begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts *on many of the broad topics addressed by the Act, accessible at* www.duanemorris.com/FinancialReform.

Title IV of the Act codifies the "Private Fund Investment Advisers Registration Act of 2010" ("Title IV"), a bill aimed at the regulation of private investment funds, including hedge funds and private equity funds. Title IV goes beyond this objective and will also require numerous small domestic and non-U.S. advisory firms to register as investment advisers. That status may have potentially adverse impacts on compensation formulas and the costs of compliance with the pervasive system of regulation of financial intermediaries.

The new legislation will significantly alter the regulatory landscape by requiring most advisors to hedge funds and trading funds as well as many smaller equity advisers to register with the U.S. Securities and Exchange Commission (the "SEC") as investment advisers and provide information about their trades and portfolios. Most currently private funds will also be required to report on membership and portfolio information. Title IV provides for greater state supervision over investment advisors and enhances government oversight and rulemaking authority related to private funds. The key changes effected by this legislation are summarized below.

SEC Registration Requirements

Elimination of the "Private Adviser" Exemption

Perhaps the most consequential provision of Title IV is the elimination of the "private adviser" exemption. Under law prior to enactment of Title IV, advisors — including advisors to private investment funds — who have fewer than 15 clients during the preceding 12 months and do not hold themselves out to be investment advisors are exempt from registering with the SEC as investment advisers under the Investment Advisers Act of 1940 (as amended, the "Investment Advisers Act"). Because most private investment funds were considered only one person — or client — advisors to such funds and pools could typically take advantage of the exemption to avoid registration. By eliminating this exemption, the new law will subject not only advisors to private hedge funds and trading funds, but also countless "small" and "family" advisors, to registration.

Title IV eliminates the availability of the intrastate exemption for advisors of private funds whose clients all reside within the advisor's home state and limits the registration exemption for investment advisers that are registered with the Commodities Future Trading Commission. As a consequence, not only will thousands of smaller advisory firms be required to register, but they will also become subject to the substantive rules and regulations that impact registered investment advisers. These regulations will limit performance-based compensation platforms and require enhanced and formalistic disclosure documents, specific books and records and standardized reporting obligations.

Limited "Foreign Private Adviser" Exemption

Title IV requires SEC registration of a foreign advisor, unless it is exempt from registration by satisfying the definition of a "foreign private adviser" where the foreign adviser: (1) has no place of business in the United States; (2) has fewer than 15 clients in total who are domiciled in or residents of the United States; (3) has aggregate assets under management attributable to U.S. clients and U.S. investors in "private funds" advised by it of less than $25 million (or such higher amount as the SEC may deem appropriate); and (4) neither (i) holds itself out generally to the U.S. public as an investment adviser, nor (ii) acts as an investment adviser to any investment company registered under the Investment Company Act of 1940 (as amended, the "Investment Company Act") or a business-development company registered under the Investment Company Act.

While many smaller non-U.S. advisors may be able to take advantage of this exemption, the majority of advisors to private funds may find the $25 million amount of assets too limiting. Beyond the fact of registration, these newly registered advisors will be required to review their fee structures to ensure compliance with the Investment Advisers' Act limitations and to create the various disclosure documents and comply with the SEC rules and regulations concerning books, records and reporting of business and investment operations.

Other Limited Exemptions

While many previously exempt advisors of private investment funds will now be required to register with the SEC, Title IV creates the following exceptions:

- Any investment advisor that acts solely as an advisor to private funds[1] and has assets under management in the United States of less than $150 million is exempt from registration.
- Title IV provides an exemption from SEC registration for advisors to "venture capital funds," as such term is to be defined by the SEC one year from the date of enactment.
- Title IV excludes "family office" from the definition of "investment adviser." The term "family office" will also be defined by SEC rulemaking, but it should be consistent with the SEC's previous exemptive policy for family offices and take into account the "range of organization, management, and employment structures and arrangements employed by family offices." The SEC's definition must include a grandfathering provision for certain advisors that were not registered or required to be registered under the Investment Advisers Act on January 1, 2010, because they provide advice solely to natural persons who invested with the family office prior to January 1, 2010, were "accredited investors" under the Securities Act of 1933 (the "Securities Act") and were officers, directors or employees of such family office at the time of their investment. There are other requirements for covered family offices. Any persons excluded from the definition of investment adviser as a result of this exception remain subject to the antifraud provisions of the Investment Advisers Act.
- Any advisor, other than a business-development company, that solely advises certain small-business investment companies licensed (or applying for a license) under the Small Business Investment Act of 1958 is exempt from registration with the SEC.

Advisors that are exempt under these provisions will still be required to maintain such records and provide such reports as the SEC "determines necessary or appropriate in the public interest or for the protection of investors."

State Registration Requirements

Under the provisions of Title IV, any private-fund advisor or manager with assets under management of at least $100 million will be required to register as an investment adviser with the SEC. Advisors that do not meet the $100 million threshold for SEC registration, and are not otherwise qualified to register with the SEC, may be subject to registration with one or more states depending on the laws of those states.

An advisor that is required to register with multiple states, and that is not otherwise eligible to register with the SEC, may register with the SEC if it has assets under management of greater than $25 million but not more than $100 million and would otherwise be required to register with 15 or more states.

Recordkeeping, Reporting and Disclosure Requirements

The Act creates the Financial Stability Oversight Council (the "Council") to assess systemic risk issues. Under Title IV, registered investment advisers to private funds will be required by the SEC to provide to the Council the data necessary for the Council to monitor systemic risk issues. These advisors will also be required to maintain records and file reports with the SEC "as necessary or appropriate in the public interest and for the protection of investors."

Registered investment advisers will be required to maintain records and file with the SEC disclosure reports about their private funds regarding: (a) the amount of assets under management and use of leverage (including off-balance-sheet leverage); (b) counterparty credit risk exposure; (c) trading and investment positions; (d) valuation policies and practices of the fund; (e) types of assets held; (f) side arrangements or side letters providing favorable terms for certain investors; (g) trading practices and (h) all other information that the SEC determines, in consultation with the Council, to be "necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk."

The SEC is required under Title IV to inspect the books and records of private funds maintained by an investment adviser, and provide an annual report to Congress describing how the SEC has used the data collected to monitor the markets for the protection of investors and the integrity of the markets.

Title IV modifies the Investment Advisers Act by adding an additional exception to the rule that client information is confidential, which would enable the SEC to require the disclosure by SEC-registered investment advisors of client information "for purposes of assessment of potential systemic risk," as well as in connection with enforcement proceedings and investigations.

However, as a way to alleviate concerns of advisors and managers of the potential that registration and reporting of their proprietary trading and portfolio information could permit third parties to reverse-engineer or copy their investment strategies and methodologies, Title IV adds a provision to the Freedom of Information Act that would exempt such information from the disclosure obligations of that law. "Proprietary information" of an investment adviser as defined by Title IV includes sensitive, non-public information regarding: (i) the investment or trading strategies of the investment adviser; (ii) analytical or research methodologies; (iii) trading data; (iv) computer hardware or software containing intellectual property and (v) any additional information the SEC determines to be proprietary.

Further SEC Rulemaking

The new law is not the final word on financial regulatory reform. The U.S. Congress has granted the SEC broad authority to make rules and regulations defining technical, trade and other terms set forth in Title IV. Two key terms that will be defined by the SEC include "venture capital fund" and "family office." The SEC has discretion to ascribe different meanings to these terms, and the scope of future regulations may not be as broad or deep as the current exemptions found in Title IV. The SEC is also authorized to prescribe registration and examination procedures for advisors to mid-sized private funds, taking into account the size, governance and investment strategy of the funds to determine whether they pose systemic risk. While the impact this may have on fund investments and operations is unknown, in the SEC's September 2003 report on hedge funds, the SEC conceded that it did not understand how private trading funds worked or why their investment portfolios consistently outperformed the portfolios of registered investment companies. The SEC contended that substantial governmental oversight was required to ensure that the credit, investment and other risks borne by such investment funds were understood by government regulators. This suggests that the new government procedures may be significant and pervasive.

Title IV also requires the SEC to adjust the net-worth standard for an "accredited investor" under Regulation D of the Securities Act. Under the Securities Act, accredited investors include natural persons with income in each of the two most-recent years in excess of $200,000 (or $300,000 for a couple) or with a net worth of $1 million either individually or jointly with the person's spouse. Title IV requires the SEC to adjust this accredited investor standard by excluding the value of a person's primary residence from the net-worth threshold. This standard would be subject to periodic adjustment by the SEC, but the SEC would not be able to make adjustments for four years after enactment. The standard would apply to new investors and to current investors making additional purchases, unless the SEC otherwise provides by rule or order. In addition, Title IV directs the SEC to adjust the "qualified client standard" set forth in the Investment Advisers Act for inflation not later than one year after the date of enactment and every five years thereafter.

Finally, as relevant to fund advisors and managers, Title IV allows the SEC in its discretion to promulgate rules to require advisors to take steps to safeguard client assets over which they have custody, including requiring verification by an independent public accountant.

Transition Period

Title IV will become effective one year after its enactment. However, any investment advisors seeking to voluntarily register prior to the enactment date may do so, subject to the existing rules of the SEC.

Enforcement Activities and Investigations

Congress and the SEC have devoted much attention to private funds during the past few years. The increasing scope of registration and reporting obligations that are likely to be imposed on advisors to private funds through Title IV are also likely to increase investigatory and enforcement actions by both the SEC and state regulators.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes videos and the firm's comprehensive series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies' interpretive guidance. For subsequent *Alerts* on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact Robert P. Bramnik, Jennifer Briggs Fisher, any member of the Broker-Dealer and Securities Regulation Practice Group, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.

Note

1. Under Title IV, a "private fund" is defined as any investment fund that would be an "investment company," as defined under the Investment Company Act, but is exempt either because it has fewer than 100 investors or because all of the investors are "qualified purchasers," which is a higher standard of qualification than an "accredited investor."