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REPORT

REGULATORY REFORM

Financial Industry Reform: New Registration, Recordkeeping, And Reporting Requirements for Private Fund Managers

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act'') will fundamentally change many aspects of financial industry regulation in the United States. Among the parties who will be particularly affected are the managers of many hedge funds and similar private investment funds that are not registered under the Investment Company Act of 1940 (the ''Investment Company Act''). Many of these fund managers currently are not registered as investment advisers with the Securities and Exchange Commission (the ''SEC'') pursuant to an available statutory exemption. Title IV of the Dodd-Frank Act, the ''Private Fund Investment Advisers Registration Act of 2010'' (the ''PF Act''), will repeal that exemption, effective as of July 21, 2011 (the ''Effective Date''), and in consequence many private fund managers will for the first time be required to register with the SEC. The PF Act also imposes significant new recordkeeping and reporting requirements on private fund managers, transfers regulatory responsibility for certain mid-sized investment advisers from the SEC to the States and amends certain other sections of the Investment Advis-

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ers Act of 1940 (the "Advisers Act"). This article summarizes the principal provisions of the PF Act.

Investment Adviser Registration

The Advisers Act requires all "investment advisers" to register with the SEC unless an exemption from registration applies. At present, many managers of hedge funds, venture capital funds, private equity funds and similar funds rely upon the registration exemption provided by Section 203(b)(3) of the Advisers Act. Section 203(b)(3) exempts from registration any investment adviser having fewer than 15 clients in any 12-month period if it does not hold itself out generally to the public as an investment adviser and does not provide investment advice to registered investment companies or "business development companies" (as defined for purposes of the Investment Company Act). In applying the numerical limit in Section 203(b)(3), investment advisers generally are permitted to count as a single "client" any hedge fund or similar private fund that they advise; they are not required to count the individual investors in such funds as separate clients. Accordingly, private fund managers have been able to rely upon the "private advisers exemption" in Section 203(b)(3) and advise a substantial number of separate funds (not more than 14 in any 12-month period) without becoming subject to SEC registration.[1]

The facts that (i) private fund managers typically have been exempt from registration under the Advisers Act, (ii) the managed funds typically have been exempt from Investment Company Act registration pursuant to the exemptions provided by Sections 3(c)(1) and 3(c)(7) of that Act (each of these sections exempts from investment company registration privately-placed investment funds if specified conditions are met) and (iii) the amount of money managed in private funds has grown significantly in recent years, created concern within Congress and the SEC that the SEC may have lacked adequate power to regulate an important segment of the investment management industry. In the PF Act, Congress addressed this concern by eliminating the private advisers exemption in Section 203(b)(3) with effect as of the Effective Date.

The elimination of the private advisers exemption will require many hedge fund and other private fund managers to register as investment advisers with the SEC. In particular, investment advisers to private funds that rely upon Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act (respectively, "private fund advisers" and "private funds"), should consider (if they are not already registered with the SEC) whether the PF Act will require them to register.

The PF Act does include certain exemptions from the registration requirement that will be available to certain private fund advisers (including, in particular, an exemption for private fund advisers with less than $150,000,000 of assets under management). At the same time, it disqualifies private fund advisers from claiming certain other existing exemptions in the Advisers Act. These new exemptions and disqualifications include the following:

1. *Foreign Private Advisers*. The PF Act creates an exemption from registration for "foreign private advisers". A "foreign private adviser" is defined as an investment adviser who has no place of business in the United States, has, in total, fewer than 15 clients and investors in the United States in private funds advised by it, has less than $25 million in assets under management attributable to clients in the United States and investors in the United States in private funds advised by it (or such higher amount as the SEC may approve by rule), and does not hold itself out generally to the public in the United States as an investment adviser or act as an investment adviser to any registered investment company or as a business development company.

2. *Venture Capital Fund Advisers*. The PF Act exempts from registration under the Advisers Act any investment adviser who provides investment advice solely to one or more venture capital funds. The PF Act does not define the term "venture capital fund", but instructs the SEC to issue final rules defining the term not later than the Effective Date. Although exempt from registration, advisers to venture capital funds will be required to maintain such records and provide to the SEC such annual or other reports as the SEC determines are necessary or appropriate in the public interest or for the protection of investors.

3. *Smaller and Mid-Sized Private Fund Advisers*. The PF Act exempts from registration under the Advisers Act any investment adviser who (i) provides investment advice solely to private funds, and (ii) has assets under management in the United States of less than $150,000,000. Any such private fund advisers will still be required to maintain such records and provide to the SEC such annual or other reports as the SEC determines are necessary or appropriate in the public interest or for the protection of investors.

4. *Elimination of Intrastate Exemption as to Private Fund Advisers*. Section 203(b)(1) of the Advisers Act currently exempts from registration any investment adviser all of whose clients are residents of the State in which the investment adviser maintains its principal office and place of business so long as the adviser does not furnish advice or issue analyses or reports with respect to any securities listed or admitted to unlisted trading privileges on any national securities exchange. The PF Act amends Section 203(b)(1) to make this exemption unavailable to private fund advisers that might otherwise qualify.

5. *Revision of Exemption for Commodity Trading Advisors*. Section 203(b)(6) of the Advisers Act currently exempts from registration any investment adviser that is registered as a commodity trading advisor with the Commodity Futures Trading Commission (the "CFTC") if such adviser's business does not consist *primarily* of acting as an investment adviser and it does not provide advice to any registered investment company or business development company. The PF Act amends Section 203(b)(6) to require any private fund adviser who is registered with the CFTC as a commodity trading advisor to register with the SEC as an investment adviser

[1] In December 2004, the SEC adopted a rule under the Advisers Act (Rule 203(b)(3)-2 (the "*2004 Rule*")) that would have required many private fund advisers to register as investment advisers. Specifically, the 2004 Rule would have made the private advisers exemption unavailable to many such advisers by requiring them to count as separate clients each of the investors in their managed funds if certain conditions applied. In June 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated the 2004 Rule, *Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006)*, and thereby made the private advisers exemption once again available to any private fund advisers who satisfied its conditions.

   ISSN 0037-0665

if its business shall become *predominately* the provision of securities-related advice. The PF Act does not define "predominately" as used in this context.

6. *Advisers to Small Business Investment Companies*. The PF Act creates an exemption from registration for any investment adviser (other than any entity regulated as a business development company under the Investment Company) whose only clients are small business investment companies licensed under the Small Business Investment Act of 1958 or certain similar or affiliated entities.

7. *Family Offices*. The PF Act directs the SEC to provide an exemption for "family offices" (as defined by the SEC by rule). Any such exemption must be consistent with the SEC's existing exemptive policy for family offices and not exclude certain grandfathered family offices. The PF Act therefore ensures that certain investment advisers who have been formed to provide investment advice to the members of a single family will continue to be exempt from registration.

The PF Act requires the SEC to assess whether "mid-sized private funds" pose "systemic risk" after taking into account their size, governance and investment strategies and to "provide for registration and examination procedures with respect to the investment advisers of such funds which reflect the level of systemic risk" that such funds pose. The SEC therefore has been directed by Congress to develop specific registration and examination procedures for investment advisers to mid-sized private funds. However, the PF Act does not define the term "mid-sized private fund".

Recordkeeping, Reporting, and Examination Requirements

The PF Act requires each registered investment adviser to maintain such records and file with the SEC such reports concerning each private fund it advises as the SEC shall specify by rule to promote investor protection or to permit the Financial Stability Oversight Council (the "Council") to assess systemic risk.[2] Without limitation to the foregoing, each private fund adviser will be required to maintain records and/or file reports describing the following matters in relation to each of its private fund clients: (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, (v) types of assets held, (vi) any side arrangements or side letters whereby certain private fund investors obtain more favorable rights than other investors, (vii) trading practices, and (viii) any other information that the SEC, in consultation with the Council, determines to be necessary and appropriate (in establishing any additional reporting requirements under this clause (viii), the SEC is authorized to establish different reporting requirements for different classes of fund advisers, based on the type or size of the private fund being advised). The SEC is to specify by rule the exact content of the required reports and the time periods for which private fund advisers must maintain the related records.

The PF Act requires the SEC to conduct periodic inspections (on such schedule as the SEC shall determine) of the records maintained by a registered private fund adviser for its private fund clients and authorizes the SEC to conduct such additional or special examinations as it deems appropriate. Each registered private fund adviser will also be obligated to provide to the SEC upon request any copies or extracts from such records that may be prepared without undue effort, expense or delay.

The PF Act requires the SEC to keep confidential any records, reports or other information supplied to it by a private fund adviser pursuant to the Act's recordkeeping and reporting requirements and such information will not be subject to compelled disclosure under the Freedom of Information Act; *provided* that the SEC is permitted to share all such information with the Council and (upon an agreement of confidentiality) with Congress and to comply with (i) information requests it receives from any other U.S. government department or agency or any self-regulatory organization acting within the scope of its jurisdiction, and (ii) disclosure orders issued by a United States court in an action brought by the United States or the SEC. Any other U.S. government department or agency or self-regulatory organization that receives any such information will be subject to the same confidentiality obligations. The PF Act further prohibits the SEC from publicly disclosing any "proprietary information" received from a private fund adviser (other than in a public hearing held by the SEC or pursuant to a court proceeding brought to enjoin a violation of the Advisers Act or in certain other specified situations). The term "proprietary information" is defined as "sensitive, non-public information" regarding (i) the adviser's investment or trading strategies, (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.

In part to implement the new recordkeeping and reporting requirements, one provision of the PF Act broadens the SEC's authority to require investment advisers to disclose client information to it. At present, Section 210(c) of the Advisers Act states that the SEC may not require any investment advisor engaged in providing investment supervisory services (i.e., the provision of continuous investment advice based on the client's individual needs) to disclose the identity, investments or affairs of any of its clients unless such

[2] The Council will be established pursuant to the Dodd-Frank Act and will be comprised of one representative from each of the principal federal financial regulators and certain other persons. Among other responsibilities, the Council has been charged with identifying and responding to emerging threats to the stability of the United States financial system.

disclosure is necessary in any investigation or proceeding directed toward the enforcement of the Advisers Act. The PF Act amends Section 210(c) so that the SEC may also require such disclosure as needed ''for purposes of assessment of potential systemic risk.'' This amendment eliminates the conflict that could otherwise exist between Section 210(c) and the expanded reporting requirements.

The SEC will be required to report annually to Congress on how it has used the data collected from private fund advisers to monitor the securities markets to protect investors and the integrity of the market.

Enhanced State Authority

The Advisers Act bifurcates regulatory responsibility for investment advisers between the SEC and the State securities commissions such that advisers (unless otherwise exempt from registration) register with the SEC, or with the State commissions, but not with both. Specifically, Section 203A of the Advisers Act prohibits an investment adviser who is subject to regulation as an investment adviser in the State in which it maintains its principal office and place of business from registering as an investment adviser with the SEC unless it has at least $25,000,000 of assets under management (or such higher amount as the SEC may specify by rule) or certain exceptions apply.[3] Investment advisers that do not meet the threshold must register with the State securities commissions, rather than the SEC, unless they qualify for an exception permitting SEC registration or are exempt from State registration.[4] The States are prohibited from requiring the registration of any investment adviser registered with the SEC.[5] The PF Act amends Section 203A to prohibit from registering with the SEC any investment adviser (a ''Covered Adviser'') who (i) is required to be registered and is subject to examination as an investment adviser in the State in which it maintains its principal office and place of business, and (ii) has less than $100,000,000 of assets under management (or such higher amount as the SEC may specify by rule). The prohibition does not apply, however, to any Covered Adviser who is an adviser to a registered investment company or a business development company or who would (if not registered with the SEC) be required to register as an investment adviser with 15 or more States. The amendments to Section 203A will transfer authority over certain mid-sized investment advisers from the SEC to the States and are intended to make additional SEC resources available for the regulation of larger private fund advisers who will become subject to SEC registration pursuant to the PF Act.

In view of these amendments, SEC-registered investment advisers whose assets under management range from $25,000,000 to $100,000,000 should consider that they may be required to withdraw from registration with the SEC, and to register in the States in which they transact business (unless registration exemptions apply), if their assets under management continue to fall below the revised SEC threshold after the Effective Date.[6]

Adjusting the Definitions of 'Accredited Investor' and 'Qualified Client'

Regulation D under the Securities Act establishes a ''safe harbor'' pursuant to which issuers may sell their securities without registering them under the Securities Act if specified conditions are satisfied. In particular, Rule 506 of Regulation D provides a safe harbor implementing the private placement exemption in Section 4(2) of the Securities Act. An issuer may sell its securities in a Rule 506 offering to ''accredited investors'' and not more than 35 non-accredited investors. Securities Act Rule 501(a) defines an ''accredited investor'' to include, among other categories of investors, any natural person who has a net worth (individually or with spouse) in excess of $1,000,000).[7] Effective immediately, the PF Act amends this net worth test so that the value of an investor's primary residence must be excluded in calculating his or her net worth.[8] It also authorizes the SEC to increase the required minimum net worth to an amount greater than $1,000,000 (as determined by the SEC), but no such change shall be made prior to July 21, 2014. The SEC further is authorized (or, in the case of the ''accredited investor'' definition in Rule 215 under the Securities Act, required) to conduct a study to determine whether other changes should be made to the definition of ''accredited investor'' as it ap-

[3] Among other exceptions, investment advisers with less than $25,000,000 of assets under management still may register with the SEC if they would otherwise be subject to registration in more than 30 States or if they are affiliated with, and have the same principal office and place of business as, an investment adviser registered with the SEC. In addition, advisers to registered investment companies must register with the SEC regardless of the amount of assets under management.

[4] Most States exempt from registration investment advisers who have no place of business in the State and whose only clients are specified categories of institutional investors. In addition, Section 222(d) of the Advisers Act prohibits the States from requiring the registration of any investment adviser who has no place of business in the State and during the preceding 12 months has had fewer than six clients who are residents of the State.

[5] The States may nonetheless require the registration of certain employees of SEC-registered investment advisers (''investment adviser representatives'') who advise natural persons and maintain a place of business in the State.

[6] Assuming that the SEC does not change its current practice in relation to SEC-registered investment advisers who cease to qualify for SEC registration, affected investment advisers would not be required to withdraw from SEC registration immediately but would have to do so within 180 days after their first fiscal year-end that follows the Effective Date.

[7] Rule 215 under the Securities Act contains a separate definition of ''accredited investor'' but uses the same net worth standard in relation to natural persons. The Rule 215 definition is applicable to offerings made under Section 4(6) of the Securities Act (Section 4(6) provides an exemption for offerings made solely to accredited investors if certain conditions are met and the offering amount does not exceed $5,000,000).

[8] Promptly after the Effective Date, the SEC published a written interpretation stating that in calculating net worth (i) mortgage indebtedness on the primary residence may be excluded from the calculation to the extent such indebtedness does not exceed the fair market value of the residence, and (ii) any amount of mortgage indebtedness on the primary residence that exceeds such fair market value should be considered a liability and deducted from the investor's net worth (http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#179.01).

   ISSN 0037-0665

plies to natural persons.[9] In addition, the Comptroller General is directed to conduct a study on the financial thresholds or other criteria that should be required to qualify for ''accredited investor'' status and eligibility to invest in private funds and to report the results of that study to Congress not later than July 21, 2013.

Section 205(a)(1) of the Advisers Act generally prohibits registered investment advisers from charging fees to clients that are calculated as a share of the capital gains or capital appreciation in the client's account. The SEC by rule, however, has provided certain exceptions to this prohibition. In particular, the SEC permits investment advisers to charge such fees to ''qualified clients''. Among other persons, this term includes any client who has at least $750,000 of assets under management with the investment adviser or who has a net worth (individually or including assets held jointly with his or her spouse) of at least $1,500,000. The PF Act directs the SEC to adjust the dollar amounts used in the definition of ''qualified client'' for inflation not later than the Effective Date, and to readjust such amounts for inflation every five years thereafter. Any adjustments to such dollar amounts must be made in multiples of $100,000.

[9] The PF Act does not change (or require the SEC to change) any of the existing criteria for ''accredited investor'' status other than the net worth test. In particular, the income test for individual investors remains unchanged (i.e., ''accredited investor'' includes any natural person with income of at least $200,000 (or $300,000 with spouse) in each of the two most recent years and a reasonable expectation of the same income level in the current year).

Possible SRO

The Comptroller General is directed to conduct a study of the feasibility of forming a self-regulatory organization to oversee private funds and to report the results of that study to Congress not later than the Effective Date.

Other Required Studies

The PF Act requires the Comptroller General and the SEC to undertake other specified studies, including a study by the Comptroller General of the compliance costs associated with the rules requiring registered investment advisers to hold client funds and securities through a ''qualified custodian'' and a study by the SEC's Division of Risk, Strategy and Financial Innovation on the state of short selling on national securities exchanges and in the over-the-counter markets and on the feasibility, benefits and costs of certain proposed changes in trade reporting procedures. Although included in the PF Act the latter study is not directly connected to investment adviser regulation.

Effective Date

Most provisions of the PF Act, including the change made to investment adviser registration reporting and recordkeeping requirements, will become effective on July 21, 2011. Prior to that date, private fund advisers may voluntarily register with the SEC, subject to applicable SEC rules. As stated above, the change made to the net worth test for accredited investors is effective immediately.