ROPES & GRAY

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The Impact of Financial Reform: Private Fund Investment Adviser Registration

On July 21, 2010, President Obama signed into law the Private Fund Investment Advisers Registration Act of 2010 (the Registration Act), as part of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.

The Registration Act substantially alters the registration and reporting schemes under the Investment Advisers Act of 1940 (the Advisers Act). Most notably, the Registration Act will require most U.S. private equity, hedge fund and other private fund investment advisers, and many non-U.S. investment advisers to private funds—in each case with assets under management above a modest threshold—to register with the Securities and Exchange Commission (SEC) as investment advisers under the Advisers Act. The Registration Act also gives the SEC the authority to require registered investment advisers to private equity and hedge funds to maintain records and file reports with the SEC concerning each private fund advised by such investment adviser as the SEC determines is necessary and appropriate in the public interest and for the protection of investors.

The Registration Act provides for a one-year transition period from the date it is enacted (*i.e.* July 2011) before the registration, record-keeping and disclosure requirements under the Advisers Act take effect. Investment advisers may register voluntarily during the one-year transition period.

Elimination of the Private Adviser Exemption

The Registration Act eliminates the so-called "private adviser exemption" from registration under Section 203(b)(3) of the Advisers Act, which exempted investment advisers that do not hold themselves out to the public as investment advisers and have fewer than 15 clients. This exemption has historically been the most commonly relied upon exemption from registration by investment advisers to "private funds."[1] In lieu of the private adviser exemption, the Registration Act introduces a number of new and narrowly-tailored exemptions from the registration requirements under the Advisers Act, including the following exemptions for:

- Investment advisers that act as an adviser solely to one or more "venture capital funds." The SEC is directed to define "venture capital fund" for this purpose and issue rules to require such investment advisers to maintain such records and provide the SEC such annual or other reports as the SEC determines is necessary or appropriate.
- "Foreign private advisers," defined as an investment adviser that: (i) has no place of business in the United States; (ii) has fewer than 15 clients and investors in the United States in private funds advised by it; (iii) has less than $25 million (or such higher amount as the SEC may deem

[1] Under the Registration Act, a "private fund" means an issuer that would be an investment company but for sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940—i.e., virtually all private equity, venture capital and hedge funds in which U.S. persons or entities may invest. Other investment advisers that have relied on the private adviser exemption (*e.g.,* advisers to managed accounts) will also be required to register under the Advisers Act unless another exemption is available.

appropriate) in assets under management attributable to U.S. clients and investors in the United States in private funds advised by it; and (iv) neither holds itself out to U.S. investors as an investment adviser, nor acts as an investment adviser to any investment company registered under the Investment Company Act of 1940 or any company that has elected to be a business development company under the Investment Company Act of 1940.

- Investment advisers that act solely as an adviser to private funds and have assets under management in the United States of less than $150 million. The SEC is directed to issue rules to require such investment advisers to maintain such records and provide the SEC such annual or other reports as the SEC determines is necessary or appropriate.
- Investment advisers to small business investment companies licensed under the Small Business Investment Act of 1958 and similar companies.

The Registration Act also limits the existing exemption under Section 203(b)(6) of the Advisers Act available to investment advisers registered with the Commodity Futures Trading Commission (the "CFTC"). If the business of a private fund investment adviser that is registered with the CFTC as a commodity trading advisor becomes predominately the provision of securities-related advice, then the investment adviser will also have to register with the SEC under the Advisers Act.

Additionally, investment advisers with less than $100 million in assets under management (or such higher amount as the SEC may deem appropriate) that are required to be registered with, and are subject to examination as an investment adviser by, the securities commissioner (or similar agency) of the state in which the investment adviser maintains its principal office and place of business will generally not be permitted to register under the Advisers Act.

New Record-Keeping and Reporting Requirements for Private Fund Investment Advisers

In addition to the existing record-keeping and reporting requirements imposed on registered investment advisers under the Advisers Act, the SEC may require registered private fund investment advisers to maintain records and file reports with the SEC concerning each private fund advised by the investment adviser. The Registration Act requires that the records and reports maintained by an investment adviser for each of its private funds include a description of:

- the amount of assets under management and use of leverage;
- counterparty credit risk exposure;
- trading and investment positions;
- valuation policies and practices;
- types of assets held;
- side arrangements or side letters with fund investors;
- trading practices; and
- such other information as the SEC, in consultation with the newly created Financial Stability Oversight Council (the "Oversight Council"), determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

The Registration Act also directs the SEC to take into account the size, governance and investment strategy of "mid-sized" private funds to determine whether they pose systemic risk, and to provide for registration and

examination procedures with respect to the investment advisers of such mid-sized private funds which reflect the level of systemic risk posed by such funds. "Mid-sized" private fund is not expressly defined in the Registration Act and therefore will presumably be defined by the SEC under its rulemaking authority.

Impact of Registration on Private Fund Investment Advisers

General. Generally, registered investment advisers in the U.S. are subject to the substantive provisions of the Advisers Act with respect to all of their clients. Accordingly, registration under the Advisers Act will require private fund investment advisers to comply with the Advisers Act and the applicable rules promulgated by the SEC thereunder, and will likely necessitate many important changes to their business and operations. For example, becoming a registered investment adviser may affect how a private fund investment adviser:

- reports its past performance in its marketing materials;
- maintains its books and records;
- drafts its investment advisory agreements with the private funds it advises;
- arranges for the custody of the private fund's assets; and
- oversees personal trading activities of its personnel.

In addition, registration under the Advisers Act will require private fund investment advisers to develop written policies and procedures reasonably designed to prevent violations of the Advisers Act, which must be overseen and administered by a designated chief compliance officer, and will subject private fund investment advisers to regular examinations by the SEC.

Non-U.S. Investment Advisers. In order to limit the extraterritorial application of the Advisers Act, the SEC has generally required non-U.S. registered investment advisers to comply with the primary substantive provisions of the Advisers Act only with respect to their U.S. clients. Once registered, a non-U.S. investment adviser to an offshore private fund has been permitted to treat the fund (rather than the fund's investors) as its "client" for purposes of applying the substantive requirements of the Advisers Act. Accordingly, non-U.S. registered investment advisers have been relieved, with certain exceptions, of the obligation to comply with the substantive provisions of the Advisers Act with respect to offshore private funds.

The SEC has required non-U.S. registered investment advisers to offshore private funds to:

- comply with certain record-keeping requirements and with the general anti-fraud provisions under the Advisers Act;
- provide SEC examiners with all records required to be kept by the investment adviser under the Advisers Act, as well as any records required to be kept under foreign law (however, a non-U.S. investment adviser has not been required to reveal the identity or other information in respect of its non-U.S. clients if otherwise prohibited by applicable foreign law); and
- not hold themselves out to non-U.S. clients as being registered under the Advisers Act.

Notwithstanding the enactment of the Registration Act, the underlying considerations for the SEC's policy of limiting the applicability of the Advisers Act to non-U.S. registered investment advisers would appear to remain valid. However, the SEC may modify this policy in light of the changes to the Advisers Act effected by the Registration Act.

Other Significant Changes to the Advisers Act and the Securities Act of 1933

Confidentiality of Information. Under the Registration Act, the SEC may not generally be compelled to disclose private fund information contained in the records and reports provided to the SEC by private fund investment advisers. However, the SEC is required to make available to the Oversight Council copies of all reports, documents, records and information filed with or provided to the SEC by an investment adviser in respect of the private funds it advises as the Oversight Council may consider necessary for the purpose of assessing the systemic risk posed by a private fund. The SEC may also be required to share such private fund information with other federal departments or agencies or self-regulatory organizations requesting the reports or information for purposes within the scope of their jurisdiction.

The Oversight Council and any department, agency or self-regulatory organization that receives reports or information from the SEC concerning private funds are required to maintain the confidentiality of such reports, documents, records and information on the same basis as the SEC. Further, the SEC, the Oversight Council and any other department, agency or self-regulatory organization that receives information, reports, documents, records or information from the SEC concerning private funds are exempt from the provisions of the Freedom of Information Act with respect to any such report, document, record or information. The SEC may not (subject to certain limited exceptions) make public any "proprietary information" of an investment adviser ascertained by the SEC from any report required to be filed with the SEC concerning its private funds. For this purpose, "proprietary information" 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 that the SEC determines to be proprietary.

The Registration Act also amends Section 210(c) of the Advisers Act, which generally prohibits the SEC from requiring a registered investment adviser to disclose the identity, investments or affairs of the investment adviser's clients, to allow the SEC to require a registered investment adviser to disclose such information for purposes of assessing potential systemic risk.

Periodic Examinations. The Registration Act directs the SEC to conduct periodic inspections of the records of private funds maintained by a registered investment adviser. Further, the SEC may conduct additional, special and other examinations from time to time as the SEC may prescribe as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk.

Custody of Client Assets. The Registration Act codifies the authority of the SEC to prescribe rules requiring registered investment advisers to take steps to safeguard client assets over which the investment adviser has custody, including verification of such assets by an independent public accountant. The SEC adopted substantial reforms to Advisers Act Rule 206(4)-2 (the "Custody Rule") in December 2009. Further information on these reforms can be found in the Ropes & Gray LLP client alert on the topic Investment Management & Hedge Funds Alert, January 12, 2010.

Qualified Client Standard. With respect to the dollar thresholds used in determining a "qualified client" for purposes of applying Section 205(e) of the Advisers Act (which relates to the ability of an investment adviser to charge a performance based fee), the Registration Act requires the SEC, not later than one year after the date of enactment of the Registration Act and every five years thereafter, to adjust the threshold to give effect to inflation (rounding up to the nearest multiple of $100,000 as necessary).

Net Worth Standard for Accredited Investors. During the four-year period following the date of enactment of the Registration Act, the net worth standard for an "accredited investor" within the meaning of Regulation D under the Securities Act of 1933 in respect of a natural person (or joint net worth with their spouse) at the time of purchase is fixed at $1 million, excluding the value of the primary residence of such natural person. The requirement to exclude the value of a person's primary residence from the calculation of "net worth" for purposes of Regulation D is a change in law. Advisers to private funds should review fund subscription documents and update such documents as appropriate to reflect this change in law.

Following the initial four-year period after enactment, the net worth standard for an "accredited investor" in respect of a natural person (or joint net worth with their spouse) at the time of purchase is required to be more than $1 million (as may be adjusted by the SEC), excluding the value of the primary residence of such natural person. Further, every four years following the date of enactment of the Registration Act, the SEC is required to undertake a review of the definition of "accredited investor" as such term applies to natural persons, to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy. Upon completion of any such review, the SEC may make such adjustments to the definition of "accredited investor" as such term applies to natural persons, as the SEC may deem appropriate for the protection of investors, in the public interest, and in light of the economy.

We continue to evaluate the impact of financial reform legislation, especially those changes that may affect the investment management, banking, hedge and private investment fund, private equity, and derivatives businesses. If you have questions concerning *Financial Reform Matters*, please contact any of the attorneys listed below or the Ropes & Gray attorneys with whom you regularly work:

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