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Private Fund Investment Advisers Registration Act Enacted Into Law

Hedge fund and private equity fund managers will now be required to register with the SEC or state regulators, while venture capital fund advisers obtain an exemption from registration.

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On July 21, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by the President. Title IV of this act, referred to as the Private Fund Investment Advisers Registration Act of 2010 (the PFIA Act), effects fundamental changes in the Investment Advisers Act of 1940 (the Advisers Act) that will result in many previously unregistered advisers registering with the U.S. Securities and Exchange Commission (SEC) or one or more state regulators. The goal of the PFIA Act is to shine regulatory light into all corners of the hedge fund and private equity fund industry and provide regulators with greater access to financial information in order to monitor systemic risk.

The Basics

Elimination of *De Minimis* Adviser Exemption. The core change to the Advisers Act is the elimination of the *de minimis* exemption to the registration requirements for small, private investment advisers. The *de minimis* exemption currently allows advisers in the United States with fewer than 15 clients during the prior 12-month period to operate without SEC registration unless, among other things, they hold themselves out to the public in the United States as providing investment advice. With the effectiveness of the PFIA Act, every investment adviser with a place of business in the United States with $100 million or more of assets under management will be required to register with the SEC regardless of the number of clients it may have. (See discussion below regarding advisers based outside of the United States.) An adviser with less than the threshold amount of assets under management will be required to comply with investment adviser registration requirements, if any, of the state in which the adviser maintains its principal office and place of business.

Advisers in the United States that are not required to register in, and be examined by, the state where their principal office is located will continue to be subject to the existing SEC registration requirements, which provide that if they manage $25 million or more but less than $30 million of investment assets, then they *may* register with the SEC. If they manage $30 million or more of investment assets, then they *must* register with the SEC. An adviser that would be required to register with 15 or more state regulators may instead register with the SEC, even though it has less than $100 million in assets under management. The legislation does not contain a "grandfather" clause that would

permit currently registered advisers to remain registered with the SEC even though they are not currently required to be registered.

Private Fund Adviser Exemption. The PFIA Act creates a limited exception from SEC registration for private fund advisers that only manage private funds (i.e., they do not accept managed accounts) and have aggregate assets under management in the United States of less than $150 million. The term "private fund" means funds operating pursuant to either the Section 3(c)(1) or Section 3(c)(7) exemption from the Investment Company Act of 1940, effectively capturing all hedge funds and private equity funds that are offered to investors within the United States.

Thus, an adviser to private funds that would otherwise need to register with the SEC once it had reached $100 million of assets under management would in fact not need to register with the SEC until it has acquired an additional $50 million of assets under management. Advisers to private funds with less than $150 million of assets under management in the United States will still need to comply with applicable state investment adviser registration requirements. Private fund advisers based in states where they would not be required to register with, and be supervised by, a state securities authority will still need to register with the SEC if they manage private funds with $30 million or more of assets.

Advisers excepted from registration with the SEC will nonetheless be subject to SEC reporting obligations and SEC examination. The PFIA Act directs the SEC, when exercising its rulemaking authority, to consider the "size, governance, and investment strategy" of mid-sized private funds to determine whether the funds pose systemic risk, and to "provide for registration and examination procedures" for advisers of such funds that reflect the level of systemic risk posed by the funds.

Venture Capital Fund Adviser Exemption. The PFIA Act exempts from registration any adviser that exclusively advises venture capital funds. Congress has directed the SEC to develop a definition of "venture capital fund" within the next year. We have no indication at the moment how the SEC will address this directive or resolve the sometimes subtle distinctions among private funds.

Foreign Advisers. An adviser with no place of business in the United States will nonetheless be required to register with the SEC if, among other things: (i) it holds itself out to the public in the United States as an investment adviser, or (ii)(a) it has 15 or more clients and private fund investors in the United States or (b) it has $25 million or more of assets under management from clients/investors in the United States regardless of the number of its clients/investors.

Accordingly, an investment adviser in Hong Kong with three managed account clients in the United States, or three U.S. investors in the adviser's offshore private funds, will have to register with the SEC if those persons have more than $25 million under management by the Hong Kong adviser. Similarly, the Hong Kong adviser will need to register if it has 16 managed account clients in the United States or 16 U.S. investors in its offshore private funds, even if the clients/investors have allocated less than $25 million to the adviser.

It would appear from the legislation that the foreign adviser only has to look through the adviser's funds that constitute "private funds" as defined under the PFIA Act (i.e., that are operating pursuant to the Section 3(c)(1) or Section 3(c)(7) exemption from the Investment Company Act). Therefore, the adviser's funds that are not offered in the United States and do not need to rely on exemptions from the

Investment Company Act may continue to have U.S. investors (assuming the admission of the investors was otherwise in compliance with the Investment Company Act), without those investors being counted against the adviser's 14 U.S. investor limit.

It is also worth noting that in accordance with longstanding SEC interpretations, the investors in a foreign adviser's offshore private funds will not be considered "clients" of the adviser (even though they must be counted in determining whether the adviser must register with the SEC) unless there is a direct contractual relationship between the adviser and the investor. Accordingly, as further explained below under "Practical Considerations," many of the substantive provisions of the Advisers Act will not apply to the relationship between such investors and the adviser, even after the adviser registers with the SEC.

Regulatory Oversight and Reporting. The PFIA Act increases the reporting requirements and regulatory oversight of private fund advisers that are required to register. In general, each private fund adviser must provide information as to the status of the following for each fund:

- Amount of assets under management
- Use of leverage (including off-balance-sheet leverage, such as swaps)
- Counterparty credit-risk exposures
- Trading and investment positions
- Trading practices
- Valuation policies and practices of the funds
- Types of assets held
- Side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors

Of particular significance to private fund advisers is the fact that the PFIA Act will now require registered advisers to treat the records of their private funds as the records of the advisers. The information contained in the reports of all advisers is to be kept confidential, although Congress and other U.S. government agencies will be permitted to share the information with each other.

The PFIA Act gives the SEC the ability to require additional information as it deems necessary. Each adviser is also subject to regulatory examinations and possible enforcement actions. Such regulatory examinations may include periodic, special, unscheduled (i.e., without notice), or other examinations as the SEC may prescribe. Further, Congress has asked the SEC to develop reporting procedures for private fund advisers that are otherwise excepted or exempted from registration, including advisers to venture capital funds.

Change in Accredited Investor Definition. Congress has instructed the SEC, in Section 413 of the PFIA Act, to increase the minimum-net-worth threshold that is used for determining whether natural persons are "accredited investors" for the purposes of the SEC's securities private placement rules. Currently, a natural person with a net worth of at least $1 million, individually or jointly with his or her spouse, will qualify as an accredited investor. Pursuant to previous SEC guidance, an investor was allowed to include the value of his or her principal residence when calculating net worth. The PFIA Act provides that no increase in the dollar amount of the threshold shall be made until after the fourth

anniversary of the enactment of the PFIA Act, but immediately upon enactment, an investor will no longer be able to include the value of a primary residence in determining his or her net worth.

The SEC has attempted on numerous occasions to change the factors used to determine a person's accreditation, recognizing that the existing definition is out of date and allows too many investors to qualify for arguably speculative investments. Congress has also directed the SEC to reassess the definition of "accredited investor" generally as it applies to natural persons. As an alternative to meeting the net-worth test, natural persons can qualify as "accredited investors" by having an income of at least $200,000 (or joint income with a spouse of at least $300,000) in the two most recent years and in the current year. The SEC may take the opportunity to change the income test and other features of the "accredited investor" definition.

Practical Considerations

For U.S. Private Fund Advisers. Hedge fund and private equity fund managers in the United States will now have to register with the SEC if they meet the assets under management threshold, and thus will become subject to the Advisers Act—just as if they managed separate accounts of individuals or institutions. Managers in the United States that have less than $150 million in assets under management must register with their state regulators if such registration is so required.

Many states, such as Florida and New York, have broad exceptions that will allow managers to remain unregistered. However, all private fund managers will likely be subject to increased regulatory reporting, whether or not they are registered, and all investment advisers remain subject to the antifraud provisions of the Advisers Act. Over time, state regulators may adopt new regulations to eliminate the gap in registration requirements. Oddly, based on the definition of "private fund," it appears that a U.S. fund manager will not be able to treat its offshore funds as "private funds" unless they are offered in the United States and thus rely on the Section 3(c)(1) or Section 3(c)(7) exemption from the Investment Company Act.

If this is a correct reading of Section 408 of the PFIA Act, then a consequence could be that—since it does not act as an adviser solely to "private funds"—the U.S. fund manager would not be eligible for the private fund adviser exception and thus would have to register with the SEC once it acquired $100 million of assets under management, rather than $150 million. This is presumably an unintended consequence and may be addressed by the SEC through the rulemaking process.

It is also unclear whether the general partners of private funds will also need to register with the SEC or state regulators when they meet the definition of adviser, because they provide limited advice to the fund and are affiliated with the registered adviser to the fund. We presume that the SEC will develop an exception for these general partners—perhaps by viewing them to be "persons associated with an investment adviser" under Section 202(a)(17) of the Advisers Act, which would obviate their need to register separately as an adviser.

For U.S. Venture Capital Fund Advisers. Developing a workable definition of "venture capital fund" may pose a significant hurdle for the SEC. In the past, the SEC has distinguished between hedge funds, on one hand, and private equity and venture capital funds, on the other, based on whether a fund permitted periodic redemptions. Distinguishing venture capital funds from other funds that would

trigger SEC registration for the adviser, based on investor liquidity, would not appear to be appropriate in this context, and so the SEC may be forced to develop even more qualitative criteria.

For example, the SEC could look for guidance to the qualification conditions for business development companies under the Investment Company Act, and in particular the definition of "eligible portfolio company," which generally encompasses companies without listed shares or with listed shares but with a total market value of less than $250 million. Alternatively, the SEC may exercise its authority to create a broader exemption including private equity funds within the definition of venture capital funds. Expanding the definition of venture capital fund in this manner would seem to rest, however, on a conclusion that private equity funds do not present any more systemic risk than do venture capital funds, which is arguably inconsistent with Congress's assessment of the need for regulation of private equity funds.

The combination of the elimination of the *de minimis* exemption (the 15-client rule), upon which many venture capital fund managers currently rely, and the new explicit carveout from any registration requirements for venture capital fund advisers means that a venture capital fund adviser (as will be defined by the SEC) will no longer be limited to fewer than 15 clients (*i.e.*, 15 venture capital funds). Consequently, any venture capital fund advisers that are self-constrained by the 15-client rule so as to avoid registration will no longer be limited by the number of funds they can manage, so long as all of the funds they manage meet the definition of "venture capital fund" to be promulgated by the SEC. Nonetheless, although still not registered, such managers will be subject to the additional reporting requirements (*see* "New Reporting Requirements" above) and will continue to be subject to the antifraud provisions of the Advisers Act.

For Foreign Investment Advisers. Many foreign advisers will now also likely need to register with the SEC, unless they meet the limited criteria for the exceptions set forth in the PFIA Act. Foreign advisers that manage less than $100 million but are not eligible for the "foreign private adviser" exemption, due to the amount of U.S. assets or number of U.S. clients that they manage, will nonetheless need to register with the SEC, even though a domestic U.S. adviser managing the same amount of assets would be exempt from registration. This is due to the fact that the foreign adviser is not required to be registered and examined by any state agency since it has no place of business in the United States, which is a prerequisite for the exemption from SEC registration for domestic U.S. advisers that manage less than $100 million.

In determining how many U.S. clients it has, a foreign adviser that manages a U.S. feeder fund will have to include the feeder fund. The foreign adviser will also have to take into account all of the investors in the U.S. feeder fund, not just the U.S. resident investors in the feeder fund, in determining how many U.S. fund investors the adviser has (although such feeder fund investors will still not need to be treated as clients of the adviser). This may require foreign fund managers to reconsider the use of Delaware LLCs as an alternative to funds formed in tax havens such as the Cayman Islands.

The extent to which subadvisory arrangements will trigger registration is not entirely clear, although subadvisers to private funds were required to register under former Advisers Act Rule 203(b)(3)-2. Further, the legislation would lead to the conclusion that a foreign fund manager with a U.S. feeder fund or stand-alone U.S. private fund may not be entitled to the private fund adviser exemption available to U.S. private fund advisers, and thus will have to register with the SEC once it acquires $25 million or more of assets under management in the United States. This conclusion is based, among

other things, on the fact that the foreign fund manager will likely manage non-U.S. funds that do not qualify as "private funds," and thus the foreign manager cannot be said to advise solely private funds.

The language in the PFIA Act does not rely on the definition of U.S. person that is derived from Regulation S under the Securities Act of 1933. This may cause some confusion when construing whether a client or investor is to be considered "a client in the U.S." The SEC will likely clarify this point in the regulations to be adopted or modified in response to the PFIA Act.

We understand in speaking with the SEC that the "regulation lite" regime will be preserved. This concept was first articulated in an SEC rule release in 2004 (and later reconfirmed by no-action letters) and provides that foreign advisers that voluntarily register or are required to register with the SEC must comply with the substantive provisions of the Advisers Act only with respect to their U.S. "clients." Under this regime, a foreign adviser will not need to treat U.S. investors in the adviser's offshore funds as "clients in the U.S." because the fund is not a U.S. client (and the investors are not clients), but will have to treat stand-alone funds and feeder funds as U.S. clients if the funds are organized under U.S. law. This may create an incentive for organizing U.S.-targeted funds in offshore jurisdictions.

Regulatory Oversight and Reporting. Congress has taken significant steps to reassure fund managers that their reports will be treated with confidentiality, and has created a disclosure exception from the U.S. Freedom of Information Act. On the other hand, a private fund adviser will need to treat the records of its private funds as its own records. As a result, an adviser will be forced to disclose to the SEC all information in the adviser's possession regarding the investors in the private funds. Such disclosure would constitute a breach of confidentiality under the laws of many jurisdictions.

Accredited Investor Definition. The exclusion of primary residences from the calculation of net worth to determine accreditation and the eventual increase in the dollar threshold will inevitably shrink the pool of eligible investors for hedge funds and private equity funds in the United States because all U.S. investors must be accredited investors. The SEC has in the past toyed with the idea of changing the net-worth test in the investment fund context into an "investments" test similar to the standard that is used for the definition of "qualified purchaser" under Section 2(a)(51) of the Investment Company Act, which is the investor qualification used for Section 3(c)(7) funds. The exclusion of an investor's primary residence from the test is a step in the direction of an investments test and the SEC may take this lead to implement fully this type of test. The PFIA Act is silent on the income test for accredited investors, although arguably the income test is as obsolete, if not more so, than the net-worth test. We can expect the SEC to address this point in its reconsideration of the accredited investor definition.

Important Dates. The transition dates for compliance with the various portions of the PFIA Act are included here for easy reference:

Registration of Investment Advisers	All advisers required to register with the SEC as result of the elimination of the *de minimis* exemption must have an effective SEC registration under the Advisers Act by the first anniversary of the enactment.

Adjustment of the Accredited Investor Net	The $1 million net-worth threshold will be increased after the fourth anniversary of the enactment. The elimination of an investor's primary residence from the net-worth test is effective immediately.

Worth Test	

Development of Definition of Venture Capital Fund	By the first anniversary of the enactment the SEC must issue final rules exempting advisers to venture capital funds from registration under the Advisers Act.

Reporting and other Provisions	Except as otherwise provided in the PFIA Act, reporting requirements and other provisions of the PFIA Act will become effective on July 21, 2011, one year after enactment.

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact the author, **Ethan W. Johnson** (212.309.2046; ejohnson@morganlewis.com), or any of the following Morgan Lewis attorneys:

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