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MEMORANDUM

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PRIVATE EQUITIES AND HEDGE FUNDS IN THE NEW LEGAL ENVIRONMENT

Registration and Compliance Requirements under the Private Fund Investment Advisers Registration Act of 2010

Key Words:

- Investment Adviser
- Private Equity
- Hedge Fund
- Real Estate Fund
- Registration and Compliance
- Exemption from Registration
- Exclusion from Definition
- Record Keeping and Reporting
- Private Fund Investment Advisers Registration Act of 2010
- Investment Advisers Act of 1940
- Investment Company Act of 1940
- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
- Securities Act of 1933
- Exchange Act of 1934

The Private Fund Investment Advisers Registration Act of 2010 (the "Registration Act"), promulgated as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, substantially amends the registration and compliance requirements imposed on investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act").

The Investment Advisers Act of 1940 (the "Advisers Act") requires any person who, for compensation, engages in the business of advising as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, to register as an "investment adviser," unless such person is either (i) qualified for exemption from registration under the Advisers Act or (ii) is excluded from the definition of "investment adviser" (for example, bank, bank holding companies and savings associations are excluded from the definition of "investment adviser" under the Advisers Act).

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A number of investment advisers to private equity, venture capital, real estate, hedge and other investment funds currently rely on the private adviser exemption from registration under the Advisers Act. The private adviser exemption is available to an investment adviser who meets the following three conditions: (i) it has fewer than 15 “clients” in the course of the preceding 12 months; (ii) it does not hold itself out generally to the public as an investment adviser; and (iii) it does not advise registered investment companies (as defined in the Investment Company Act of 1940) (mainly mutual funds) or business development companies (such as venture capital funds). Many private equity, venture capital, real estate, hedge and other private fund managers have been able to rely on the private adviser exemption because the Advisers Act allows an adviser to count as a “single” client any corporation, general or limited partnership, limited liability company or business trust if the adviser provides the organization with investment advice based on the organization’s objectives rather than the individual investment objectives of the organization’s owners/investors.[1]The Registration Act amends the Advisers Act by eliminating the private adviser exemption, but it provides for new exemptions from registration as well as new reporting and recordkeeping obligations to be established by the Securities and Exchange Commission (the "SEC") for registered and certain unregistered investment advisers as described below.

Unless otherwise specifically noted herein, the provisions of the Registration Act described below will not become effective until July 21, 2011. These provisions require implementing rules and regulations to be established within the same one-year period. This means that investment advisers that are currently not registered with the SEC will have 12 months to assess their operations, to determine whether they can still be qualified for exemption under the new law, and to adopt appropriate policies and procedures to comply with the Advisers Act, the Registration Act, and other related laws and regulations.

A. Adviser Registration under the Registration Act

1. **Elimination of the “Private Investment Adviser” Exemption.** The Registration Act eliminates the “private investment adviser” exemption and will require many investment advisers that are currently exempt from registration to register with the SEC under the Advisers Act, unless a definitional exclusion is available or another exemption from registration is available.

2. **New Exemptions from Registration.** The Registration Act includes new exemptions from registration for (i) advisers to “venture capital funds,” (ii) “foreign private advisers,” (iii) advisers to certain “private funds” and (iv) advisers to licensed small business investment companies (“SBICs”).

a) ***Advisers to “Venture Capital Funds” Exemption***. Advisers that solely advise one or more “venture capital funds” will be exempt from registration under the Advisers Act. The Registration Act requires the SEC to define “venture capital fund” within one year of enactment of the Registration Act. Notwithstanding the venture capital fund exemption, the Registration Act requires advisers to venture capital funds to comply with new recordkeeping and reporting requirements (to be established by the SEC). The principal effect of this new exemption is that advisers to venture capital funds will no longer be subject to the 14 “client” limit so long as they are solely advising venture capital funds. Investment advisers that advise both venture capital funds and other types of funds will be required to register under the Advisers Act, unless another exemption is available.

b) ***"Foreign Private Advisers" Exemption***. Certain non-U.S. advisers will be exempt from registration under the Advisers Act as "foreign private advisers." The Registration Act defines a "foreign private adviser" as any investment adviser that (i) has no place of business in the United States, (ii) has, in total, fewer than 15 clients in the United States in the private funds (as defined below) advised by the adviser, (iii) has aggregate assets under management attributable to such clients of less than $25 million and (iv) neither holds itself out to the public in the United States as an investment adviser nor advises registered investment companies (mainly mutual funds) or business development companies.

c) ***Advisers to Certain "Private Funds" Exemption***. The Registration Act instructs the SEC to provide an exemption for those advisers that have assets under management in the United States of less than $150 million and that solely advise "private funds." The Registration Act defines a "private fund" as any fund that would be an "investment company" under the Investment Company Act of 1940 (the "Investment Company Act"), but for the exceptions from the definition of "investment company" under Section 3(c)(1) (the 100 beneficial owners exception) or Section 3(c)(7) (the "qualified purchaser" exception) of the Investment Company Act. The Registration Act, however, provides that advisers to private funds that qualify for this type of exemption are still subject to the new recordkeeping and reporting requirements that are to be established by the SEC.

d) ***Advisers to Licensed SBICs Exemption***. Advisers that solely advise one or more SBICs (and/or entities affiliated with any such SBICs that have an application pending with the Small Business Administration and/or entities that have received from the SBIC notice to proceed to qualify for a license as an SBIC) will be exempt from registration under the Advisers Act.

3. **Modifications to Existing Exemptions from Registration**. The Registration Act also modifies two existing exemptions from registration for (i) intrastate advisers and (ii) certain commodity trading advisers registered with the Commodity Futures Trading Commission (the "CFTC").

a) ***Intrastate Advisers*****.** The Registration Act maintains the intrastate adviser exemption under the current law for an adviser whose clients all reside in the state within which the adviser maintains its principal place of business and that does not provide advice or issue analysis or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange, but it modifies the exemption to provide that no adviser that acts as an investment adviser to a "private fund" may rely on it.

b) ***Advisers Registered with the CFTC***. The Registration Act maintains the CFTC-registered adviser exemption under the current law, which permits a registration exemption for an investment adviser (i) that is registered with the CFTC as a "commodity trading adviser"; (ii) whose business does not primarily consist of acting as an investment adviser; and (iii) none of whose client is an investment company registered under the Investment Company Act (such as mutual funds) or a business development company. In addition, the Registration Act provides an exemption for any CFTC-registered commodity trading adviser that advises a private fund unless the adviser renders predominately securities-related advice. An SEC-registered investment adviser, by contrast, may still have to register as a commodity trading adviser with the CFTC depending on its activities.

4. **Exclusion of "Family Offices" from the definition of "Investment Adviser."** The Registration Act modifies the definition of "investment adviser" to exclude any "family office," which is not defined in the

Registration Act. The SEC will issue rules or regulations regarding the definition of "family office" that recognize the range of organizational, management and employment structures and arrangements of family offices.

5. **Exclusion of "Mid-Sized Investment Advisers."** Under the Advisers Act, investment advisers that are subject to state regulation in their home states, have less than $25 million in assets under management and do not advise registered investment companies (such as mutual funds) are not permitted to register with the SEC. The Registration Act increases the minimum assets under management required for SEC registration to $100 million (or such higher amount as the SEC deems appropriate), and prohibits SEC registration for any such "mid-sized investment adviser" unless such adviser (i) would be required to register in 15 or more states, (ii) advises registered investment companies or business development companies or (iii) is not required to be registered and subject to examination in its home state.

6. **The Definition of "Client."** The Registration Act provides that the SEC may not define the term "client" to include an equity owner in a private fund advised by an investment adviser that has entered into an advisory agreement with that adviser. This means that an adviser may still be able to count its fund-client (limited liability companies, partnerships, etc.) as a "single" client as long as it provides advice to the fund based on the organization's investment objectives rather than the investment objectives of its equity owners or investors.

7. **Specific Implications on Advisers to Private Equity, Real Estate and Hedge Funds**. As discussed above, as a general rule, the Registration Act does not (unless clarified through SEC rulemaking) provide exemptions from registration for advisers to private equity, real estate or hedge funds.

a) ***Private Equity Funds***. Unless private equity funds can fit within the definition of "venture capital funds" (which will be defined by the SEC within the one-year period) or are qualified for another exemption from registration (other than the private adviser exemption they currently rely on as it is eliminated), advisers to private equity funds that currently rely on the private adviser exemption will be required to register with the SEC by July 21, 2011.

b) ***Real Estate Funds***. The Registration Act does not provide an exemption for advisers to "real estate funds." An investment adviser to real estate funds that is currently relying on the private adviser exemption will have to determine (i) whether a different exemption is available and/or (ii) whether, based on its investment strategy, it does not fall within the definition of an "investment adviser." Real estate fund advisers that restrict their investments to real property held directly in their funds or through wholly owned subsidiaries may be able to conclude that they do not fall within the definition of "investment adviser." Investment advisers that invest in securities, such as REITs, mortgages or mezzanine debts, or wish to have the flexibility in structuring co-investment arrangements among parallel funds or with third parties, may find it difficult to conclude that they do not fit within the definition of "investment advisers."

c) ***Hedge Funds***. The legislative intent to amend the Advisers Act was specifically targeted at the advisers to hedge funds, and hedge fund advisers that currently rely on the private adviser exemption will be required to register with the SEC by July 21, 2011 unless they can qualify for a different exemption discussed above.

B. Recordkeeping and Reporting Requirements

1. ***Registered Advisers***. The Registration Act enhances the SEC's recordkeeping, reporting and inspection authority over registered investment advisers and the private funds that they advise. The SEC is permitted to require registered investment advisers to maintain records of, and file with the SEC reports regarding private funds advised by such advisers, as is necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk. In addition to any other information that the SEC determines is necessary and appropriate, the Registration Act requires registered investment advisers to maintain and make subject to SEC inspection records and reports for each private fund they advise that include (i) the amount of assets under management and use of leverage, including off-balance-sheet leverage, (ii) exposure to counterparty credit risks, (iii) investment and/or trading positions, (iv) valuation policies and practices of the fund, (v) types of assets held, (vi) side arrangements with investors and (vii) trading practices.

A registered adviser must maintain the above-mentioned records for such period as the SEC establishes by rule and may be required to file reports containing such information as the SEC determines by rule. The SEC may at any time conduct special and other examinations as the SEC determines is necessary and appropriate (including examinations of the records of persons having custody over an adviser's clients' assets) in the public interest and for the protection of investors, or for the assessment of systemic risk.

2. ***Unregistered Advisers***. The Registration Act provides that certain advisers that are exempt from registration will still be subject to new recordkeeping and reporting requirements, which will be established by the SEC.

C. Rule 205-3 Performance Fee Restrictions and the “Qualified Client” Standard

Under the current law, a registered investment adviser is permitted to charge a performance fee to clients that are either a “qualified client,” a “qualified purchaser” (as defined in the Investment Company Act) or a “knowledgeable employee” of the adviser. A “qualified client” must have at least $750,000 in assets under management with the adviser or have a net worth of more than $1,500,000.

The Registration Act provides that, for purposes of determining the dollar amount thresholds contained in the definition of “qualified client” in Rule 205-3 under the Advisers Act, no later than one year after the date of enactment of the Registration Act and every five years thereafter, the SEC is required to adjust such thresholds for the effects of inflation (rounded to the nearest $100,000). The principal effect of this amendment will be to raise the monetary threshold that clients and equity owners of certain private funds must meet before the adviser can charge such clients and/or owners a performance fee.

D. Modified “Accredited Investor” Standard

The Registration Act modifies the net worth standard for an “accredited investor,” as set forth in Rule 501 promulgated under the Securities Act of 1933. Effective as of July 21, 2010, and for a period of four years thereafter, the individual net worth for any natural person (or joint net worth with such person's spouse) must continue to be in excess of $1 million at *the time of purchase*, but such individual must now exclude the value of his or her primary residence for purposes of determining his or her net worth. During that four-year period, the SEC may review and adjust any other aspect of the definition of "accredited investor" as it applies to natural persons. On or after the fourth anniversary of the date of enactment, and not less frequently than once every four years thereafter, the SEC is required to review the definition of "accredited investor" in its entirety as it applies to natural persons to determine whether the requirements of the definition should be adjusted for the protection of investors, in the public interest and in light of the economy.

Advisers should update the subscription agreements for private investment funds to reflect the new definition of "accredited investor" and establish procedures to deal with the new higher standards for both "accredited investors" and "qualified clients." Advisers may need to refuse new investments from existing private fund investors that do not meet the new thresholds.

E. Other Provisions of Interest under the Dodd-Frank Wall Street Reform and Consumer Protection Act

Other provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") that may also affect investment advisers to certain private investment funds (particularly as rules are promulgated) are as follows:

Advisers (particularly those within banks and bank holding companies) may need to consider the effects of the Volcker Rule on their business, clients, their funds, and equity owners of their funds. This is because the Advisers Act excludes bank, bank holding companies and savings associations from the definition of "investment adviser," and therefore, they currently need not register under the Advisers Act or comply with any of the provisions of the Advisers Act, including the antifraud provisions of §206. Advisers in these institutions may be subject to the new registration and compliance requirements of the federal securities laws as a result of the Volker Rule.

Certain private funds or advisers ultimately may be determined to be "nonbank financial companies" that are designated by the Financial Stability Oversight Council (the "Council") as "systemically important" and therefore required to register with the Federal Reserve and subject to more stringent standards and capital requirements.

The Act gives the SEC rulemaking authority to shorten the period for filing reports under Section 13(d) (5% ownership) and Section 16 (short swing profits) of the Securities Exchange Act of 1934 (the "1934 Act") and the Act amends the reporting requirements of Section 13(d) and Section 13(f) (institutional investment managers) with respect to security-based swap agreements.

The Act instructs the SEC to adopt rules providing for at least monthly public disclosure of short sales by institutional investment managers under Section 13(f) of the 1934 Act, and the Act also makes unlawful a "manipulative short sale of any security" and requires the SEC to issue rules to ensure the availability of enforcement options and remedies for violations of this prohibition.

The Act gives the SEC rulemaking authority regarding securities loans and directs it to issue rules designed to increase the transparency of information available to broker-dealers and investors with respect to such loans.

The regulatory landscape for investment advisers has changed. We will continue to monitor the progress of the Registration Act and any other related proposals and will advise on material developments.
To discuss these matters further, please contact our attorneys.

[1] Accordingly, there is no need to "look through" an entity and count its individual owners as clients of the adviser when determining whether the adviser has "fewer than 15 clients." In addition, two or more entities that meet the condition described above may be counted as a "single client" if those entities have identical investors. See Advisers Act Rule 203(b)(3)-1(a)(2)(ii).
