LATHAM & WATKINS

Number 1055 July 15, 2010

Client Alert

Latham & Watkins
Corporate Department

# Financial Services Regulation Bill Will Require Most Sponsors of Private Equity, Real Estate and Hedge Funds to Register as Investment Advisers

"Although the provisions of the Act become effective one year from its date of enactment, private fund advisers should consider their upcoming registration status and begin developing the compliance policies and procedures they would need as a registered investment adviser."

On July 15, 2010, the US Senate approved the Dodd-Frank Wall Street Reform and Consumer Protection Act. President Obama is expected to sign the bill into law promptly. The law includes the Private Fund Investment Advisers Registration Act of 2010 (Act), which substantially amends the registration and compliance requirements under the Investment Advisers Act of 1940 (Advisers Act) for investment advisers to private funds.[1] Private fund sponsors with assets under management of US $150 million or more (other than "venture capital" sponsors and "family offices") will be required to register as investment advisers with the US Securities and Exchange Commission (SEC). The Act also imposes additional compliance and reporting obligations on SEC-registered private fund advisers.

The Act impacts both US and non-US advisers. In particular, non-US sponsors of private funds (whether organized in the US or elsewhere) will be subject to investment adviser registration with the SEC if US $25 million or more of their fund commitments are derived from US investors.

The provisions of the Act will take effect one year from the date of enactment.

This *Client Alert* briefly reviews the Act and its implications for registration of private fund sponsors under the Advisers Act. We note that the Act is only one part of the larger Dodd-Frank Act, which effects sweeping changes to the overall US regulation of the financial services industry.[2]

## Adviser Registration

### Repeal of "Private Adviser" Exemption from SEC Registration

Most private fund advisers fall within the definition of "investment adviser" under the Advisers Act and, absent an exemption, would be required to register with the SEC.[3] While some private fund advisers are already registered under the Advisers Act, many other advisers have relied on the "private adviser" exemption from registration set forth in Section 203(b)(3) of the Advisers Act. Specifically, prior to the Act, an investment adviser that (i) did not hold itself out generally to the public as an investment adviser, (ii) had fewer than 15 clients during the preceding 12-month period and (iii) did not act as an investment adviser to any registered investment company or business development company, was not required to register under the Advisers Act. A private fund adviser could consider each private fund vehicle it managed (rather than the private fund's investors) as its client for these purposes so long as the adviser provided investment advice based on the investment objectives of the vehicle as a whole (as opposed to the individual investment objectives of vehicle investors).

The Act eliminates the "private adviser" exemption. As a result, most private fund advisers that previously relied on this exemption will be required to register with the SEC as an "investment adviser" under the Advisers Act, unless one of the remaining exemptions applies. The repeal of the "private adviser" exemption can also be expected to expand the reach of the Advisers Act, notably to investment vehicles or structures not commonly associated with the provision of investment advice.

Registered investment advisers are required, among other things, to provide certain information to clients and to maintain compliance programs, to observe restrictions on affiliated transactions, custody of client assets and payment of compensation, and to maintain prescribed books and records. Registered investment advisers also are subject to periodic inspections by the SEC.

*Venture Capital Exemption*. Under the Act, advisers solely to one or more "venture capital funds" are exempted from registration. The SEC is required to develop a definition of "venture capital funds" through rulemaking within one year of adoption of the Act. While there can be no assurance as to the nature of the exemption that will be promulgated, we believe the relief will be narrowly crafted. Moreover, irrespective of registration, the SEC is directed to require venture fund advisers to maintain such records and file such reports with the SEC as the SEC determines necessary or appropriate in the public interest or for the protection of investors. As a result, even advisers that fall within the "venture capital" exemption will still be subject to additional Advisers Act requirements.

*Family Offices*. The Act provides that "family offices" are excluded from the definition of "investment adviser." Again, the SEC is required to define "family office" through rulemaking.

*Federal Registration Threshold*. Prior to the Act, advisers generally required assets under management of at least US $25 million in order to be eligible for SEC registration, and SEC registration was mandatory for advisers managing at least US $30 million (unless an exemption from registration applied). The Act decisively increases the threshold for mandatory SEC registration to US $150 million.

*Enhanced Role of State Registration*. Private fund sponsors not subject to federal registration will need to consider whether they are subject to registration and substantive regulation under state adviser regulations. While in broad terms, state-level regulations have historically been similar to the SEC scheme, each state must be analyzed independently. Moreover, registration in one state will not pre-empt the potential registration requirements of any other state in which an adviser may do business.

## "Foreign Private Adviser" Exemption

Under the Act, a substantial number of non-US advisers to private funds — both US and non-US — can be expected to be required to register with the SEC. The Act provides only a limited exemption for "foreign private advisers," defined under the Act as any adviser that:

- Has no place of business in the United States
- Has, in total, fewer than 15 US clients and US investors in private funds advised by the adviser

- Has less than US $25 million in aggregate assets under management "attributable" to US clients and to investors in the adviser's private funds. The SEC may increase this threshold through rulemaking
- Neither holds itself out generally to the public in the US as an investment adviser, nor acts as an adviser to any registered investment company or business development company

The US $25 million limit on US-sourced assets under management by an adviser may arise from the commitments or other assets of any US-based private funds as well as from the commitments of US investors in private funds (regardless of whether organized in the US or outside the US). As a result, many non-US private fund advisers will need to register with the SEC.

## Enhanced Substantive and Reporting Requirements

The SEC is authorized to require advisers to maintain records and file reports with the SEC regarding private funds advised by the adviser. Such reports would also be provided to the newly created Financial Stability Oversight Council (Council), and the SEC is required to consult with the Council in determining the scope of the reporting requirements. For this purpose, the records and reports of any private fund advised by an adviser will be deemed the records and reports of the adviser. At a minimum, the records and reports required to be maintained in respect of private funds will include a description of:

- The amount of assets under management
- Use of leverage, including off-balance-sheet leverage
- Counterparty credit risk exposure
- Trading and investment positions
- Valuation policies and procedures
- Types of assets held
- Any side letters and other similar agreements, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors
- Trading practices

The SEC is authorized to establish different reporting requirements for different classes of private fund advisers, based on the type or size of private fund being advised.

*Additional SEC Reporting*. The Act requires the SEC to issue rules requiring private fund advisers to file reports with such information as the SEC deems necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. The reports, documents and other records filed with or provided to the SEC may be shared with the Council for the purpose of assessing the systemic risk posed by a private fund.

*Inspections*. The SEC is also required to conduct periodic inspections of the records of private funds, pursuant to a schedule to be established by the SEC. The SEC may conduct additional, special and other examinations.

*Confidentiality*. The additional information provided to the SEC regarding private funds pursuant to the Act will be treated as confidential. Likewise, to the extent such information is provided to the Council, it will be exempt from Freedom of Information Act (FOIA) discovery.

*Annual Report to Congress*. The SEC is required to report annually to Congress on how the SEC has used the data it gathers from private funds to monitor the markets for the protection of investors and the integrity of the markets. In view of the scrutiny that has been applied to the private fund industry, this reporting process may well lead to further regulatory initiatives.

## Increasing Investor Eligibility Standards

Most private fund offerings rely on Rule 506 of Regulation D under the Securities Act to support their exemption from registration under the Securities Act of 1933. Among other things, Rule 506 offerings are generally limited to investors that are "accredited investors." In general terms, for individual investors, the "accredited investor" test requires either an annual income of US $200,000 (US $300,000 with spouse), or a net worth of US $1 million. The Act requires that the SEC adjust any net worth standard under any Securities Act rules — including Regulation D — in order to exclude the value of the primary residence of a natural person in determining whether they meet the US $1 million net worth standard. After four years, and at least once every four years thereafter, the SEC is required to review the definition of "accredited investor" as applied 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.

Moreover, registered investment advisers are subject to limits on the types of clients that may be charged "performance fees," that is, fees such as carried interest which are based on the performance of the investment portfolio. Under present law, such performance fees may be charged to non-US investors, and also to US investors that are qualified purchasers, or that have either net worth of US $1.5 million or assets under management with the adviser of US $750,000. The Act requires that the SEC adjust these "qualified client" standards for inflation within a year of the adoption of the Act, and every five years thereafter.

## Potential SRO for Private Funds

The Comptroller General is required to study the feasibility of forming a self-regulatory organization to oversee private funds. The initial report will be filed within one year of the adoption of the Act.

## Conclusion

The repeal of the "private adviser" exemption, and the relatively narrow limits of the "foreign private adviser" exception from registration, will require the registration of many private fund advisers, as well as participants in a variety of investment transaction structures, to registration under the Advisers Act.

Although the provisions of the Act become effective one year from its date of enactment, private fund advisers should consider their upcoming registration status and begin developing the compliance policies and procedures they would need as a registered investment adviser. Coupled with the announced initiative by the SEC's Division of Investment Management to focus on private fund compliance matters, it is crucial for advisers to develop, enforce and maintain effective compliance programs.

If you have any questions about this *Client Alert*, please contact Barton Clark (DC) or Brynn Peltz (NY) or any other member of the Latham & Watkins Investment Funds Group including:

***New York***

**Brynn D. Peltz**
+1.212.906.2913
brynn.peltz@lw.com

**Kathleen A. Walsh**
+1.212.906.1626
kathleen.walsh@lw.com

**Andrea J. Schwartzman**
+1.212.906.2952
andrea.schwartzman@lw.com

***Washington, D.C.***

**Barton B. Clark**
+1.202.637.1009
barton.clark@lw.com

***Los Angeles***

**Scott P. Klein**
+1.213.891.7586
scott.klein@lw.com

***San Diego***

**Nadia S. Sager**
+1.619.238.2865
nadia.sager@lw.com

**Endnotes**

1 For purposes of the Act, a "private fund" is defined as any issuer of securities that would be an "investment company" as defined in the Investment Company Act of 1940, but for the exclusions provided in Section 3(c)(1) or 3(c)(7) of that Act. Most private investment funds employ these exclusions. To qualify, a fund may not make or propose to make a public offering of its securities, and either its outstanding securities must be beneficially owned by not more than 100 persons (the "3(c)(1) exclusion"), or its outstanding securities must be exclusively owned by persons who are, at the time of acquisition, "qualified purchasers" (the "3(c)(7) exclusion"). Qualified purchasers, in general, include natural persons with at least US $5 million in investments or entities that own and invest on a discretionary basis at least US $25 million in investments.

2 *See*, for example, *"Proxy Access, Say on Pay and Other Key Corporate Governance and Executive Compensation Provisions Under the Dodd-Frank Bill / House Approves Bill; Senate Expected to Vote Mid-July"*, Latham & Watkins LLP Corporate Governance Alert, July 6, 2010; *Proxy Access and Executive Compensation Provisions of the Dodd-Frank Wall Street Reform Act: What Companies, Boards and Compensation Committees Need to Know and Do Now*, Latham & Watkins LLP Corporate Governance Webcast upcoming July 31, 2010.

3 Subject to certain exceptions, an "investment adviser" is defined under the Advisers Act to mean any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

---