Regulation of Private Funds and Their Advisers Under the Dodd-Frank Wall Street Reform and Consumer Protection Act

August 3, 2010

I. INTRODUCTION

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), a broad overhaul of the nation's financial regulatory system. The Act's passage represents the culmination of a 13-month effort that began with the release of the Obama administration's "white paper" on financial regulatory reform, followed by the negotiation of separate bills in the U.S. House of Representatives and Senate and finally the reconciliation and passage of the Act. This memorandum focuses on the provisions of the Act that alter the registration, reporting and recordkeeping obligations applicable to private funds and their advisers. Previously, private equity and hedge fund advisers generally were not required to register with the Securities and Exchange Commission ("SEC") or comply with related reporting, recordkeeping and other burdens in reliance on the "private investment adviser" exemption under the Investment Advisers Act of 1940 (the "Advisers Act"). Under the Act, however, private equity and hedge fund advisers will be required to register with the SEC if their advisee funds and other client accounts have $150 million in assets or more under management. Advisers solely to "venture capital funds," regardless of their size, are not required to register, although they will be subject to certain reporting requirements. The registration, reporting and recordkeeping obligations become effective one year after the Act is enacted.[1]

While the Act establishes a framework for heightened regulation of the private funds industry, the provisions of the Act are in many respects incomplete (and in some cases intentionally so), and Congress has authorized the SEC and other federal regulators to fill in these gaps and complete this process through further analytical review, rulemaking and interpretation. This administrative process will dictate important aspects of the reform and the exact ways in which the new legislation will affect private funds and their advisers. As a result, it will likely be quite

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[1] For an overview of the entire Act, including areas not covered by this memorandum, please refer to our recently published memorandum entitled "U.S. Congress Nears Completion of Landmark Financial Services Reform Legislation", a copy of which is available at www.simpsonthacher.com/content/Publications/pub1013.pdf. For more specific information on the component of the Act known as the "Volcker Rule", which generally bans banking organizations from sponsoring or investing in private equity funds and hedge funds and engaging in proprietary trading, please see our memorandum, "The Volcker Rule Provisions in the Dodd-Frank Reform and Consumer Protection Act", which is available at www.simpsonthacher.com/content/publications/pub1014.pdf.

some time until such reforms are broadly implemented and the direct and indirect impact of the Act on the private funds industry is fully understood.

II. PRIVATE FUND ADVISER REGISTRATION AND REPORTING REQUIREMENTS

A. Registration of Investment Advisers to Private Funds

Under pre-Act regulations, many private fund advisers—including advisers to what are colloquially referred to as hedge funds, private equity funds and venture capital funds—were exempted from registration with the SEC, regardless of the amount of their assets under management, in reliance on the "private investment adviser" exemption in the Advisers Act.[2] The Act significantly changes this framework.

Most notably, the Act has eliminated the private investment adviser exemption contained in Section 203(b)(3) of the Advisers Act and thereby generally requires (subject to the exceptions noted below) the registration of all advisers to "private funds." The Act defines a "private fund" as an issuer that would be an "investment company" under Section 3 of the Investment Company Act of 1940 (the "Investment Company Act") but for the exemptions provided in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.[3] As a result, investment advisers to most private funds, subject to certain exceptions, will now be required to register with the SEC. An adviser will not be required to register with the SEC if it acts solely as an adviser to private funds and has assets under management in the United States of less than \$150 million.[4] In

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2 Section 203(b)(3) of the Advisers Act provides an exemption for an investment adviser that (i) has had fewer than fifteen clients during the preceding twelve months (each fund vehicle is generally treated as a separate client for this purposes), (ii) does not hold itself out generally to the public as an investment adviser and (iii) does not act as an investment adviser to any registered investment company or business development company.

3 Section 3(c)(1) of the Investment Company Act generally exempts an issuer that has 100 or fewer holders of its securities (other than short-term paper) and that does not engage or propose to engage in a public offering of securities. Section 3(c)(7) of the Investment Company Act generally exempts an issuer all the security holders of which are "qualified purchasers" and that does not engage or propose to engage in a public offering of securities. An important interpretive issue to be clarified by the SEC is the application of the definition of "private funds" to foreign investment funds. Based on conversations with the SEC staff and Commissioners, we believe there is reason to expect that the SEC will only treat as "private funds" those foreign investment funds that have U.S. advisers or that offer or sell their securities to U.S. residents, so that foreign investment funds that neither have U.S. advisers nor offer or sell their securities to U.S. persons (even though U.S. persons may acquire such securities in secondary market transactions not arranged by the adviser) will not be treated as private funds.

4 For this purpose, the Act does not define the term "assets under management" or specify how and when "assets under management" will be tested. For example, whether advisers to private equity funds should test on the basis of aggregate capital commitments, aggregate capital contributions, fair value of their advisee funds' investments or some other metric. However, for other purposes of the Advisers Act, including Form ADV and Section 203A, "assets under management" are calculated based on the current fair value of the securities portfolios for which the adviser provides continuous and regular supervisory or management services.

addition, advisers solely to "venture capital funds," regardless of their size, are not required to register. The term "venture capital funds" is not defined in the Act, but the Act directs the SEC to issue rules, within one year of the effectiveness of the Act, to provide for a definition.[5]

Investment advisers solely to venture capital funds (as well as investment advisers solely to other private funds with assets under management below the $150 million threshold) are exempt from the Act's registration requirements, but will still be subject to certain reporting and recordkeeping requirements. In each case, the SEC will at some point in the future specify the reports to be maintained and provided to the SEC based on what it deems "necessary and appropriate in the public interest or for the protection of investors." Therefore, the practical effect of falling within these exemptions remains uncertain since the SEC may impose recordkeeping and reporting requirements on such exempted advisers that are similar to those imposed on registered advisers.

The Act also contains a provision that provides a potential exemption from registration (and more limited reporting obligations) for advisers to "mid-sized private funds." The term "mid-sized private funds" is not defined, and it is unclear when the SEC will issue rules providing for a definition and what, if any, exemption or more limited reporting obligations will be provided for such advisers.[6] In determining which investment advisers will benefit from the potential exemption, the SEC is required by the Act to take into account the size, governance and investment strategy of the advised funds to determine whether they pose systemic risk.

In addition, the Act creates a new limited exemption from registration for "foreign private advisers." This foreign private adviser exemption will be available to any adviser that meets all of the following criteria: (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 the adviser, (iii) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the adviser of less than $25 million (such amount may be increased by the SEC) and (iv) neither holds itself out generally to the public in the United States as an investment adviser nor acts as an investment adviser to any registered investment company or business development company. Since the exemption is so narrowly crafted, it will significantly expand the extra-territorial application of the Advisers Act for foreign investment advisers which manage capital on behalf of U.S. investors, which may, in turn, result in restricted access by U.S. investors to the services of non-U.S. advisers.

Notably, under the "foreign private adviser" exemption, an adviser must count the number of investors in the United States in its private funds (as well as its managed account "clients" in

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5 Based on our conversations with SEC staff and Commissioners, we expect that this exemption will be narrowly drafted and will focus on advisers to funds that primarily provide privately negotiated financings to start-up enterprises.

6 Although the term "mid-sized private fund" is not defined, the Act does refer to "mid-sized investment advisers" (in the context of the interplay between state and federal adviser registration described below) as an adviser with assets under management in excess of $25 million but less than $100 million.

the U.S.). Including U.S investors in private funds in this counting metric is a reversal of the methodology set forth in the *Goldstein v SEC* decision in 2006.[7] The term "investors" is not defined for purposes of this exemption and it is not clear whether an investor participating in multiple funds sponsored by the same adviser would be counted separately in determining the aggregate number of U.S. investors. As a related matter, the Act prohibits the SEC from defining the term "client" to require "look-through" treatment for purposes of applying the general anti-fraud prohibitions in Sections 206(1) and (2) of the Advisers Act to investors in a private fund advised by an adviser if the private fund has entered into an advisory contract with the adviser. It does not, however, limit the applicability of Rule 206(4)-8, which the SEC passed following the *Goldstein* ruling, to prohibit advisers to pooled investment vehicles from making materially misleading statements or omissions to investors or prospective investors in those vehicles.

The Act also exempts from registration with the SEC any adviser (i) registered with the Commodity Futures Trading Commission as a commodity trading advisor and advising private funds, so long as the business of the adviser is not predominantly providing securities-related advice and (ii) to a small business investment company, which is licensed under the Small Business Investment Act of 1958. Further, the Act provides that any "family office" does not fall within the definition of "investment adviser" as such term is defined in the Advisers Act. The Act delegates to the SEC the authority to define "family office" as part of its rulemaking process, which definition must be consistent with previous SEC exemptive orders and interpretations.

Additionally, the Act modifies the interplay between state and federal adviser registration by expanding the prohibition on federal registration to include any adviser (i) with assets under management in excess of $25 million but less than $100 million (either such amount may be increased by the SEC), (ii) that is required to register with the individual states in which the adviser maintains its principal office and principal place of business and (iii) that, if registered, would be subject to examination by such state regulatory authorities.[8] (It should be noted in

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7 In *Goldstein v SEC*, the U.S. Court of Appeals for the D.C. Circuit struck down the SEC's hedge fund adviser registration rule on the basis that the SEC exceeded its authority by defining the term "client" to require advisers to "look-through" their advisee funds for client-counting under such rule.

8 Currently, Section 203A of the Advisers Act provides that an adviser with less than $25 million of assets under management (such amount may be increased by the SEC) is prohibited from federal registration and such adviser would therefore be required to register with each applicable state that maintains an investment adviser statute, unless an exemption under such state statute applies and subject to the national *de minimis* standard provided in Section 222 of the Advisers Act (providing that an adviser may not be required to register in any state in which it (i) does not have a place of business and (ii) during the previous 12 months had fewer than 6 clients who are resident of such state). In addition, Rule 203A-1 of the Advisers Act provides that an adviser with at least $30 million of assets under management must register with the SEC (unless an exemption from registration is available), and which would therefore allow such adviser to withdraw its registration from any state regulatory authorities, although it would seem that this registration requirement would now be subject to the prohibition on federal registration by

this regard that New York State, where many fund managers are located, does not appear to have an investment adviser examination program.) If, however, this expanded prohibition would require an adviser to register with 15 or more states, then the adviser may register with the SEC (in lieu of registration with each applicable state regulatory authority).[9] In making these changes, the Act seeks to shift the regulatory responsibility for smaller investment advisers to the state securities agencies in order to reduce the burden on the SEC that is expected to result from the elimination of the "private investment adviser" exemption. However, it remains to be seen whether this effort will be effective given that a number of states have no or limited registration and/or examination requirements.

B. Reporting and Recordkeeping Requirements

Advisers of private funds that are required to register with the SEC will be subject to new reporting and recordkeeping requirements. (Advisers to private funds will also become subject to the existing reporting and recordkeeping provisions of the Advisers Act.) The Act authorizes the SEC to require registered investment advisers to maintain records (for such periods as the SEC prescribes) and file such reports with the SEC as deemed necessary or appropriate in the public interest or for purposes of "systemic risk" assessments made by the newly established Financial Stability Oversight Council (the "Council").[10] All such records will also be subject to periodic and special examination by the SEC.

The records required to be maintained (and made available for SEC inspection and subject to SEC filing requirements to be prescribed) in respect of each private fund advised by an investment adviser will include information on (i) the amount of assets under management, (ii) use of leverage, including off balance sheet leverage, (iii) counterparty credit risk exposure, (iv) trading and investment positions, (v) valuations policies and practices, (vi) types of assets held, (vii) side arrangements or side letters whereby certain investors in a fund obtain more favorable rights or entitlements than other investors and (viii) trading practices of the fund. Such private funds will also be required to maintain (and make available to the SEC) "such other information" as the SEC, in consultation with the Council, determines is "necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk." The Act provides that the "other information" requirements may include the establishment of different reporting requirements for different classes of fund advisers, based on the type or size of private fund being advised. The broad "other information" category provides the SEC significant latitude in determining what information may be required and the specific content and form of the reports to be filed with the SEC are not detailed in the Act. As a

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advisers with less than $100 million of assets under management and which are subject to state registration and examination requirements, as described above.

9 The Act also provides that an adviser to a registered investment company or business development company must register with the SEC, irrespective of its assets under management.

10 The Act establishes a ten-member Financial Stability Oversight Council, chaired by the Treasury Secretary, to identify and manage systemic risk in the financial system and improve interagency cooperation.

result, the exact impact and burden of private fund advisers' SEC reporting obligations will not be known until such obligations are fleshed out through SEC rulemaking.

To the extent that any "proprietary information" of a private fund is contained in reports required to be filed with the SEC, the Act provides for protections from public disclosure under the Freedom of Information Act. The term "proprietary information" is defined to include sensitive, non-public information regarding the investment or trading strategies of the investment adviser; analytical or research methodologies; trading data; computer hardware or software containing intellectual property; and any additional information that the SEC determines to be proprietary. The Act requires the SEC to report to Congress annually about how it used data it collected to monitor markets and protect investors and the markets.

The Act provides that the new registration requirements under the Act for advisers of private funds do not eliminate any registration obligations of such advisers, if any, under the Commodity Exchange Act. Additionally, the SEC and the CFTC are required, in consultation with the Council, no later than one year after enactment, to jointly establish rules governing the form and content of reports to be filed with the SEC and with the CFTC by investment advisers registered both under the Advisers Act and the Commodity Exchange Act.

C. Implementation/Timing

Title IV of Act, which contains the private fund adviser registration, reporting and recordkeeping provisions, takes effect one year after the date of enactment (i.e. July 2011). During this period, the SEC is expected to adopt the rules and regulations relating to registration and reporting, which will dictate the true impact of these reforms on the private funds industry. During this one year phase-in period, advisers may voluntarily register with the SEC. As part of this rulemaking process, the SEC is expected to provide guidance regarding the transition from the existing to the new registration regime (for example, whether an investment adviser with $75 million of assets under management that has previously registered with the SEC will be required to de-register and instead register with the relevant state regulatory authorities).

III. ACCREDITED INVESTOR ELIGIBILITY

Since 1982, issuers have been able to rely on the safe harbor of Regulation D under the Securities Act of 1933 to issue securities in private placements without registering those securities with the SEC. Under Rule 506 of Regulation D, an issuer may sell an unlimited amount of unregistered securities to investors that are "accredited investors."[11] The purpose of this qualification is to limit such an offering to those investors with sufficient financial sophistication and ability to

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[11] Under the rules, an individual qualifies as an accredited investor if that individual meets either of two tests: (i) the individual's net worth, or joint net worth when combined with his or her spouse, (*including the value of his or her primary residence*) exceeds $1 million at the time the securities are purchased (the "net worth test"); or (ii) the individual had income exceeding $200,000, or joint income with his or her spouse exceeding $300,000, in each of the two most recent years, and that individual or couple expects to meet those income thresholds in the current year (the "income test").

evaluate the risks and rewards of making the investment. Recently, the SEC has expressed concern that the existing accredited investor standards for individuals are outdated, as they have not been adjusted over the past 28 years to account for inflation or the increase in property values. To address this concern, the Act requires the SEC to modify the accredited investor standard such that, effective immediately upon enactment, and for four years thereafter, the net worth test will be $1 million, *excluding* the value[12] of the investor's primary residence. Although the dollar threshold for the net worth test is not being increased, by excluding the value of an investor's primary residence, the Act has effectively tightened the eligibility standards. The Act authorizes the SEC to review and modify the accredited investor definition applicable to individuals "as appropriate for the protection of investors, in the public interest, and in light of the economy". Moreover, the Act requires the SEC to conduct such a review every four years. Therefore, although the Act does not directly modify the income test or increase the dollar threshold for the net worth test to adjust for almost three decades of inflation, it is likely that the SEC will do so as part of its subsequent review process.[13]

IV. QUALIFIED CLIENT STANDARD

Currently, any client of an investment adviser (whether or not registered), including an investor in a private fund, that is charged an incentive fee or carried interest must be a "qualified client"[14]. To be a qualified client, an investor must either (i) have $750,000 in assets invested with the adviser, (ii) have a net worth in excess of $1.5 million, (iii) be a "qualified purchaser" for purposes of the Investment Company Act or (iv) be one of certain high-level employees of the investment adviser. As with the accredited investor standard, critics have voiced concern that the dollar thresholds for the qualified client standard, which was last updated in 1997, are not adjusted for inflation and therefore, certain financially unsophisticated investors may now be considered qualified clients.

In response, the Act requires the SEC, within one year of enactment and every 5 years thereafter, to adjust for inflation the dollar amounts used in the qualified client standard (with any adjustments to be made in $100,000 increments). Although this potential change would not affect "3(c)(7) funds"[15] given that all "qualified purchasers" are automatically "qualified clients", such a change may impact fundraising for "3(c)(1) funds"[15] as the minimum eligibility requirements for investing in such a fund will now be more restrictive.

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[12] The Staff of the SEC has announced interpretive guidance that the amount of any debt that is secured by an individual's primary residence (i.e., mortgage debt) should be excluded from the test (along with the gross value of the residence) so long as the gross value of the residence exceeds the amount of its mortgage debt (and if the residence has negative net equity, the amount of the negative net equity should be included as a liability in calculating the individual's net worth).

[13] However, the Act restricts the SEC from adjusting the net worth test for the first four years after enactment.

[14] Advisers Act Rule 205-3

[15] See Note 3 above.

V. GAO STUDIES

In addition to authorizing, and in some cases requiring, the SEC to review the funds-related regulations as described above, Congress has delegated related analyses to its own investigative arm, the U.S. Government Accountability Office ("GAO"). Such mandate includes a review by the GAO of the following items: (i) the feasibility of forming a self-regulatory organization to oversee private funds, with a report on this subject due to Congress not later than one year following enactment and (ii) the appropriate criteria for determining the financial thresholds and other criteria to qualify as an accredited investor and eligibility to invest in a private fund with a report due to Congress within three years of enactment.[16]

VI. CONCLUSION

While the passage of the Act represents a significant development in the regulation of the private funds industry, over the next several years, a significant number of studies, rules and regulations required by the Act will be prepared and implemented. As this process unfolds, the impact of the new legislation on the private funds industry will become more clear. We will continue to monitor and report on the progress of these regulatory developments.

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16 Unlike the SEC study related to the definition of accredited investors discussed in Section III above, the GAO review would apply more broadly to the eligibility criteria for both individual and institutional investors.

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