TITLE IV: Regulation of Advisers to Hedge Funds and Others

The Private Fund Investment Advisers Registration Act of 2010 (the "PFIARA"), Title IV of the Act, requires that investment advisers to hedge funds, private equity funds, real estate funds, and certain other private funds with assets under management ("AUM") of $150 million or more register with the SEC, comply with certain SEC books, records, and reporting requirements, and be subject to periodic SEC examination. Advisers to venture capital funds will not be required to register with the SEC, but will be required to maintain records and provide annual and other reports prescribed by the SEC. These amendments become effective one year after the enactment of the Act.

The Act provides exemptions from registration for family offices and certain foreign private advisers with fewer than 15 clients and investors, and also provides a limited intrastate exemption.

A. Exemptions

1. Elimination of Private Adviser Exemption

The Act amends Section 203(b)(3) of the Investment Advisers Act of 1940 ("Advisers Act") to eliminate the 15 or fewer client exemption that currently allows many advisers to avoid registration with the SEC. Accordingly, advisers to hedge funds and private equity funds will be required to register with the SEC if they have at least $150 million of AUM. **Sec. 403 (p. 200)**. A "private fund" is defined as an issuer that would be an investment company, as defined in Section 3 of the 1940 Act, but for Section 3(c)(1) or 3(c)(7) thereof. **Sec. 402 (p. 199)**.

The SEC is prohibited from defining the term "client" for purposes of the Advisers Act's antifraud provision, Section 206, to include an investor in a private fund managed by an investment adviser if the fund has entered into an advisory contract with the adviser**. Sec. 406 (p. 203).**

This provision will require the registration of many previously exempted investment advisers to hedge funds and private equity funds, although the threshold for SEC registration will be reset to at least $100 million AUM.

2. Limited Foreign Private Adviser Exemption

The exemption for foreign private advisers is narrower than under current Section 203(b)(3) of the Advisers Act because, among other things, it requires the adviser to look through the private fund and count the number of U.S. investors in the fund as well as the fund itself in determining whether the adviser exceeds the limit of 15 clients <u>and</u> investors in the United States. **Sec. 403 (p. 200)**. To be exempt, an investment adviser must meet the definition of "foreign private adviser," which means that it:

i. Has no place of business in the United States;

ii. Has, in total, fewer than 15 clients and investors in the United

States in private funds advised by the investment adviser;

iii. Has aggregate AUM attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million, or such higher amount as the SEC may determine through rulemaking; 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 (i) any investment company registered under the 1940 Act, or (ii) a company that has elected to be a business development company under the 1940 Act (a "Business Development Company"). **Sec. 402 (p. 199).**

This provision could potentially bring many foreign investment advisers with very few U.S. contacts under the ambit of SEC registration. The narrowing of this exemption may ultimately affect foreign advisers' decisions on whether to seek U.S. investors.

3. Limited Intrastate Exemption

The intrastate exemption found in Section 203(b)(1) of the Advisers Act for advisers to funds whose clients are all residents of the state within which the adviser has its principal office and place of business is narrowed to exclude investment advisers to private funds, except for foreign private advisers, as discussed above. **Sec. 403 (p. 200)**.

4. Limited Small Business Investment Company Adviser Exemption

New Section 203(b)(7) exempts from registration investment advisers who solely advise:

i. Small business investment companies that are licensees under the Small Business Investment Act of 1958 ("Small Business Companies");

ii. Entities that have received from the Small Business Administration notice to proceed to qualify for a license as a Small Business Company, which notice or license has not been revoked; or

iii. Applicants that are affiliated with one or more Small Business Companies that have applied for another license, which application remains pending.

Advisers that are Business Development Companies, however, are not exempt. **Sec. 403 (p. 200)**.

5. Venture Capital Fund Advisers

New Section 203(*l*) of the Advisers Act exempts venture capital fund advisers from registration under the Advisers Act with respect to investment advice provided to venture capital

funds. Even though not required to register with the SEC, venture capital fund advisers will be required to maintain such records and to provide annual or other reports to the SEC as the SEC deems necessary or appropriate in the public interest or for the protection of investors. The SEC is required to define the term "venture capital fund" within one year of enactment of the Act. **Sec. 407 (pp. 203-04)**.

The availability of this exemption will depend on the SEC's definition of "venture capital funds." Venture capital firms will want to provide input on the SEC's proposals to make sure that they are included within the definition, and advisers to other private funds will want to evaluate whether the funds that they manage are more appropriately described as "venture capital funds." Moreover, the benefit of this exemption largely will depend upon the scope of the recordkeeping and reporting requirements promulgated by the SEC for venture capital funds.

6. Private Fund Advisers with AUM of Less Than $150 Million

The SEC has authority, pursuant to new Section 203(m) of the Advisers Act, to exempt from registration any investment adviser that solely advises private funds, as defined above, and has AUM in the United States of less than $150 million. Even if exempted from registration, such advisers must maintain records and provide to the SEC such annual or other reports as the SEC determines are appropriate. In developing registration requirements and examination procedures for these "mid-sized" private fund advisers, the SEC is required to take into account fund size, governance, investment strategy, and level of systemic risk posed by the fund. **Sec. 408 (p. 204)**.

As with advisers to venture capital funds, mid-size private fund advisers will need to await the SEC's coming rulemaking as to recordkeeping and reporting requirements that will be imposed on such advisers.

7. Family Offices

Section 202(a)(11)(G) of the Advisers Act is amended to exempt from the definition of "investment adviser" (and therefore, from registration) any family office, as that term is defined by the SEC. This definition is to be consistent with SEC exemptive orders in effect at the time of enactment of the Act and to recognize the range of organizational, management, and employment structures and arrangements utilized by family offices. Even if an investment adviser is exempt from registration under this provision, it will be subject to the antifraud provisions of Section 206 of the Advisers Act. **Sec. 409 (pp. 204-05)**.

Codification of the exemption through the SEC's definition of "family office" will eliminate the need for individual exemptions for family offices, but clients with family offices will want to review the SEC's definition, when proposed, to make sure that they are covered by the exemption.

B. Federal and State Jurisdiction

The AUM threshold for an investment adviser to register with the SEC was raised from $25 million to $100 million in Advisers Act Section 203A(a)(1). Accordingly, investment advisers that do not satisfy the higher AUM requirement will be required to register with the

states rather than with the SEC, unless they are (1) advisers to an investment company registered under the 1940 Act, (2) Business Development Companies that have not withdrawn their election under the 1940 Act, or (3) required to register with 15 or more states. **Sec. 410 (pp. 205-06); Sec. 419 (p. 209)**.

This provision will require many mid-size investment advisers to register with one or more states rather than the SEC, although the Act includes a one-year transition period during which any adviser may, at its discretion, register with the SEC. It is possible that advisers who are currently registered with the SEC will be grandfathered in so that they can retain their registrations, even if they will not meet the new AUM requirement.

As a result of the increased burden on state regulators, we may see higher state registration and licensing fees, regulatory sharing agreements between states, and other changes to help the states manage their additional responsibilities and expenses.

C. Data, Reports, and Disclosures of Private Funds

New Section 204(b) of the Advisers Act requires registered investment advisers to maintain records and make reports to the SEC regarding private funds advised by the adviser, as determined by the SEC to be necessary in the public interest and for the protection of investors. The SEC is, in turn, required to provide such reports or records to the Council as the Council determines are necessary to assess the systemic risk of a private fund. For these purposes, the records of any private fund advised by an investment adviser would be deemed the records and reports of the investment adviser. The SEC is required to adopt rules specifying the types of records that private fund advisers must make, the retention period for such records, and the reports such advisers will be required to file. **Sec. 404 (pp. 200-01)**.

1. Required Information; Consultation with the Council

The records and reports required to be maintained by an investment adviser and subject to SEC inspection include, for each private fund, a description of:

i. The amount of AUM and use of leverage, including off-balance sheet leverage;

ii. Counterparty credit risk exposure;

iii. Trading and investment positions;

iv. Valuation policies and practices of the fund;

v. Types of assets held;

vi. Side arrangements or side letters whereby certain investors in the fund obtain more favorable rights or entitlements than other investors;

vii. Trading practices; and

viii. Such other information as the SEC determines, in consultation with the Council, is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. This could result in different reporting requirements for different classes of private fund advisers based on the type or size of the fund being advised. **Sec. 404 (p. 201).**

2. Examinations of Records and Confidentiality

Records of private funds that are maintained by a registered investment adviser are subject to periodic, special, and other examination by the SEC at any time and from time to time, as the SEC may prescribe as necessary and appropriate. The SEC is required to make available to the Council all reports, documents, records, and information filed with or provided to the SEC by an investment adviser to a private fund for systemic risk assessment purposes. All such reports, documents, records, and information obtained from the SEC under this section would be required to be kept confidential pursuant to Section 204(b)(8) of the Advisers Act.

The SEC is also required to provide this information to: (a) Congress, upon an agreement of confidentiality; (b) any other federal department or agency or SRO requesting information or reports for purposes within the scope of its jurisdiction; or (c) pursuant to a court order in an action brought by the SEC or otherwise by the U.S. government. The Council and any department, agency, or SRO that receives information or reports from the SEC is subject to the same level of confidentiality as the SEC. In addition, all such parties are exempt from the requirements of the Freedom of Information Act (5 U.S.C. §552) ("FOIA"), which compels federal agencies to disclose to the public any records requested in writing, unless such records are protected by an exemption under FOIA.

Any "proprietary information" of an investment adviser that the SEC ascertains from any report required to be filed with the SEC is subject to the same limitations on public disclosure as any facts ascertained during an examination as set forth in Section 210(b) of the Advisers Act. "Proprietary information" includes sensitive, non-public information regarding an adviser's investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property, and other information the SEC determines is proprietary. **Sec. 404 (pp. 201-03)**.

Section 210(c) of the Advisers Act now authorizes the SEC to disclose the identity of an investment adviser's clients for the purpose of assessing potential systemic risks as well as in connection with a proceeding or investigation relating to the enforcement of the Advisers Act. **Sec. 405 (p. 203)**.

It is not yet known what the examination protocols will be with respect to registered investment advisers to private funds. While the SEC's examinations of private fund records initially may be broad, as SEC staff develops additional experience with the private funds generally and with the newly registered advisers specifically, we may see more tailored examination protocols. The scope of information that will be required and shared among regulators in order to assess systemic risk remains a concern, particularly with respect to sensitive information such as client identity.

D. Dual SEC-CFTC Registered Advisers

Within one year of enactment of the Act, and after consultation with the Council, the SEC and the CFTC are required to jointly promulgate rules to establish the form and content of reports required to be filed with the SEC and CFTC by investment advisers that are dually registered with both agencies. **Sec. 406 (p. 203)**.

E. Custody of Client Accounts

New Advisers Act Section 223 requires registered investment advisers to take SEC-prescribed steps to safeguard client assets over which they have custody, including but not limited to verification of such assets by an independent public accountant. **Sec. 411 (p. 206)**.

The Comptroller General is required to conduct a study on the compliance costs associated with the current SEC rules regarding custody of funds or securities of clients of investment advisers as well as the additional costs if the provisions relating to operational independence are eliminated. The report is due to the Banking Committees within three years of the Act's enactment. **Sec. 412 (p.206)**.

F. Adjustment of the Accredited Investor Standard

The Act increases the net worth standard for an "accredited investor," as defined by the SEC under the Securities Act of 1933 (the "1933 Act") to more than $1 million of net worth, excluding the value of an individual's primary residence, for a natural person, or joint net worth with spouse, at the time of purchase. During the first four years following enactment of the PFIARA, the net worth standard is set at $1 million, excluding the person's primary residence. **Sec. 413 (pp. 206-07)**.

The SEC is directed to review the definition of "accredited investor" as it applies to natural persons to determine if any adjustments should be made to the requirements, other than to the net worth standard, for investor protection, public interest purposes, and in light of the economy. Beginning four years after enactment of the PFIARA, and every four years thereafter, the SEC is directed to review the definition of "accredited investor" in its entirety to determine if it should be modified for investor protection, public interest purposes, and in light of the economy. **Sec. 413 (p. 207)**.

The Act also requires that all dollar amount tests employed with respect to any factor used in any SEC rule or regulation promulgated with respect to Advisers Act Section 205(e), including the net asset threshold test, be adjusted one year after enactment of the PFIARA and every five years thereafter for the effects of inflation. **Sec. 418 (p. 208)**.

The Comptroller is required to conduct a study on the appropriate criteria for determining financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds. The report is due to the Senate Banking Committee and House Financial Services Committee within three years of enactment of the PFIARA. **Sec. 415 (p. 207)**.

This adjustment to the accredited investor standard does not apply retroactively.

Additional adjustments to the accredited investor standard may be made in the next few years, following the completion of the Comptroller's report.

G. SRO for Private Funds

The Comptroller is required to conduct a study on the feasibility of forming an SRO to oversee private funds. The report is due within one year of enactment of the Act. **Sec. 416 (p. 208)**. This study is in addition to the SEC's study of the regulation and oversight of broker-dealers and investment advisers, which is due in six months, and is expected to address the issue of an SRO for investment advisers. If the Comptroller recommends the formation of an SRO, it is unclear at this point who would comprise the entity, the scope of its regulatory authority, and whether the states would incorporate the concept of an SRO into their regulatory regimes.

H. Short Selling Studies

The SEC's Office of Risk, Strategy, and Financial Innovation is required to conduct a study on the state of short selling on national securities exchanges and in over-the-counter markets, including the incidence of the failure to deliver shares sold short. The report, together with any recommendations for market improvements, is due within two years of enactment of the PFIARA. **Sec. 417 (p. 208)**.

This office is also required to conduct a study on the feasibility, benefits, and costs of requiring real-time reporting of short sale positions either publicly or to the SEC and the Financial Industry Regulation Authority and of conducting a voluntary pilot program by public companies in which the companies agree to have additional information about their trades reported in real time though the Consolidated Tape. This report is due within one year of enactment of the PFIARA. **Sec. 417 (p. 208)**.

The full impact of these studies, as well as the other studies required by the PFIARA, will not be known until they have been completed and any recommendations adopted or rejected. However, given the nature of the studies, heightened regulation of trading activities is possible in the next few years.

I. Effective Date

The PFIARA is effective within one year of enactment, however, during that one year period, investment advisers may register with the SEC under current standards, including the $24 million AUM threshold. **Sec. 419 (p. 209)**.