Private Fund Manager Registration Act Signed into Law: Hedge Funds and Private Equity Funds Over $150M Required to Register; Venture Capital Funds are Not

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In General. On July 21, 2010, the Private Fund Investment Advisers Registration Act of 2010 (the "Act") was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Financial Reform Act"), which was signed into law by President Obama. The Act eliminates the so-called private adviser exemption for advisers with fewer than 15 clients, upon which most private fund managers relied to avoid registration under the Investment Advisers Act of 1940 (the "Advisers Act"). That provision provided an exemption from registration for any adviser that did not hold itself out as an adviser and had fewer than 15 clients during the preceding 12-month period. For purposes of counting to 15 under this former provision, each fund, rather than each fund investor, counted as a "client."

Advisers Subject to Registration Under the Act. The private adviser exemption has been replaced with a general requirement (subject to certain exemptions discussed below) that an investment adviser to any private equity fund or other private pool of capital must register with the SEC. The Act provides the following exemptions from this registration requirement:

- ***Venture Capital Funds:*** The Act provides an exemption from registration for investment advisers who manage only "venture capital funds," and directs the SEC to define the term "venture capital fund" within one year of the enactment of the Act. Such advisers would still be subject to certain disclosure and recordkeeping requirements to be defined by the SEC. It is not clear whether this "venture capital fund" exemption will cover funds-of-funds that invest only in venture capital funds.

- ***Foreign Private Advisers:*** The Act exempts from registration a "foreign private adviser," which is defined as an investment adviser that (a) has no place of business in the United States, (b) has fewer than 15 clients in the United States, (c) has less than $25 million in assets under management attributable to United States clients or investors in private funds managed by the adviser, and (d) does not hold itself out generally to the public as an investment adviser and does not act as an adviser to any registered investment company

or business development company. For purposes of the requirements of clauses (b) and (c), investors in private equity funds (and not the funds themselves), and their commitments to such funds, are counted toward the 15 client/investor and $25 million thresholds.

- ***Advisers Solely to Private Funds With Less Than $150 Million Under Management:*** The Act exempts from federal registration certain investment advisers who manage only private funds and have less than $150 million in assets under management in the United States. As a result, certain advisers with less than $150 million under management that had previously not registered with any state because they were registered with the SEC may now be required to de-register with the SEC and become subject to state registration. Advisers that are exempt from federal registration under this exemption will nonetheless be subject to certain disclosure and recordkeeping requirements to be defined by the SEC.

- ***Other Advisers With Less Than $100 Million Under Management:*** The Act provides that an investment adviser that provides investment advice to clients other than private funds (*e.g.*, an adviser with separate accounts) shall not be subject to federal registration if the adviser (a) has less than $100 million in assets under management and (b) would be required to register with (and be subject to examinations by) the state in which it maintains its principal office and place of business. However, if an adviser otherwise would be required to register with 15 or more states as a result of not registering with the SEC, then the adviser shall be permitted to register with the SEC. Advisers that are exempt from federal registration under this exemption will nonetheless be subject to certain disclosure and recordkeeping requirements to be defined by the SEC.

- ***Family Offices:*** The Act directs the SEC to engage in rulemaking to exempt "family offices" from registration.

Requirements Applicable to Registered Advisers. The key requirements applicable to advisers required to register under the Advisers Act are as follows:

- ***Registration of Adviser:*** A fund manager that is required to register as an investment adviser must register with the SEC using Form ADV.

- ***Compliance Programs:*** Each registered adviser must adopt written policies and procedures reasonably designed to prevent and detect violations of the federal securities laws. In addition, each adviser must designate an individual as Chief Compliance Officer. The Chief Compliance Officer need not be an employee of the firm, and advisers may thus outsource this function. Each registered adviser must conduct and document an annual review of the effectiveness of its compliance program.

- ***Code of Ethics; Insider Trading Policy:*** Each registered adviser is required to adopt a written code of ethics that requires covered personnel to comply with the federal securities

laws and sets forth general standards of fiduciary duty that an adviser's personnel must observe. In particular, the code must set forth standards governing personal securities trading by the adviser's personnel and require covered personnel to report personal securities holdings and transactions periodically and to pre-clear purchases in IPOs and private placements. In addition, each registered adviser must establish, maintain and enforce written policies and procedures reasonably designed to prevent insider trading.

- ***Books and Records:*** Registered advisers are required to maintain a long list of financial and other business-related books and records, in part to facilitate SEC inspections.

- ***Custody:*** Registered advisers that have "custody" (defined broadly under the Advisers Act to cover virtually all private fund managers) must keep all client assets with a qualified custodian (generally a bank or a broker-dealer) and satisfy requirements for client/investor statements detailing what assets are held by whom. If their funds do not obtain audited financials complying with GAAP and distribute them promptly to investors, the advisers must obtain an annual surprise verification of client assets by independent accountants.

- ***Proxy Voting:*** Registered advisers may exercise voting authority over client portfolio securities only if they comply with certain requirements designed to ensure that they vote in accordance with their fiduciary duties.

- ***Disciplinary Events:*** A registered adviser is required to disclose to clients and the SEC certain information about its finances and disciplinary events involving the firm, its personnel and certain "advisory affiliates."

Expanded Recordkeeping, Reporting and Disclosure Requirements.

The Act further requires registered advisers to maintain records and provide confidential reports with respect to certain information related to systemic risk, such as the amount of assets under management, the use of leverage, including off-balance sheet leverage, counterparty credit risk exposures, trading and investment positions, trading practices, valuation policies, side letters and any other information the SEC and the systemic risk regulator deems necessary and appropriate.

Transition Period. The Act provides a one-year transition period before the registration requirements under the Act take effect. Accordingly, investment advisers that previously relied on the private adviser exemption and that are required to register as investment advisers under the Act must register with the SEC by July 21, 2011 under the terms of the Act. However, given that the SEC has until July 21, 2011 to define the meaning of "venture capital fund," it is possible that the SEC will issue rules extending this one-year transition period.

Other Noteworthy Items.

- ***Revised Accredited Investor Standard:*** The Act revises the definition of "accredited

investor" set forth in Regulation D of the Securities Act of 1933 to exclude the value of a natural person's primary residence for purposes of determining whether the person meets the $1 million net worth standard. Notwithstanding the one-year transition rule under the Act, the staff of the SEC has stated that it takes the position that this revision takes effect immediately. The Act also directs the SEC not to further adjust the $1 million net worth standard for a period of four years following the enactment of the Act.

- ***Limitations on Banks Sponsoring or Investing in Private Funds:*** Another portion of the Financial Reform Act which is relevant to private investment funds is the so-called "Volcker Rule". The Volcker Rule generally prohibits a banking entity from acquiring or retaining any ownership interest in or sponsoring a hedge fund or private equity fund. A banking entity may make and retain an investment in such a fund if certain requirements are met, including that (a) the amount invested by such banking entity in a private equity fund or a hedge fund does not exceed 3% of the total ownership interests of the fund, and (b) the aggregate amount invested by such banking entity in private equity funds and hedge funds does not exceed 3% of the banking entity's "tier 1" capital. In addition, a banking entity may sponsor such a fund if the fund is offered only to limited trust or other banking customers and certain other restrictions are satisfied.

- ***SEC's Renewed Focus on Use of a Registered Broker-Dealer:*** In general, a person who effects securities transactions and receives transaction-based compensation must register as a broker-dealer. The SEC has broadly interpreted the reach of these and other relevant factors to include various marketing and referral activities (including "finder" activities) in connection with the sale of securities. While the guidance from the SEC and its staff has been vague, the SEC staff has noted that in some circumstances it may be necessary for fund marketing personnel, whether employed by the fund manager or by a third-party finder, to be associated with a registered broker-dealer. While this is not a new requirement, the SEC staff has recently indicated that non-compliance with this requirement is an area of particular concern to the SEC.

- ***Pay-to-Play Rules:*** On June 30, 2010, the SEC unanimously adopted Rule 206(4)-5 and amendments to Rules 204-2 and 206(4)-3 under the Advisers Act. Rule 206(4)-5 is designed to prohibit "pay-to-play" activity (i.e., contributions by an investment adviser or its employees to public officials in order to influence their selection of investment advisers). The text of the rule provides that it applies to investment advisers that are registered (or required to register) with the SEC, as well as to investment advisers that are exempt from registration in reliance on the private adviser exemption.[1] Under the rule, such investment advisers whose funds or direct advisory services are marketed to state or local governments must adopt procedures to restrict or prohibit contributions by the advisers and their employees to government decision-making officials and may not compensate third-party marketers unless the marketers are registered broker-dealers (for fund marketing) or SEC-registered advisers (for direct advisory services).

If you have any questions about the matters addressed in this alert, or if the WilmerHale Fund Formation Group or Investment Management Group can be of assistance to you in determining whether you are required to register or in completing the registration process, please contact Robert G. Bagnall (+1 202 663 6974; robert.bagnall@wilmerhale.com) or your regular WilmerHale Fund Formation Group or Investment Management Group contact.

[1] While there is some ambiguity as to whether the rule will apply to investment advisers who manage only venture capital funds now that the private adviser exemption has been repealed by the Act, we expect that the rule will be clarified to provide that it does apply to such investment advisers.

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