Paul Hastings
StayCurrent
A Client Alert from Paul Hastings
July 2010

A New Era in the Regulation of Private Investment Funds

BY INVESTMENT MANAGEMENT AND PRIVATE INVESTMENT FUNDS PRACTICE

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") - which became law on July 21, 2010 (the "Enactment Date") – marks a new era in the regulation of private investment funds, including hedge funds and many private equity and real estate funds, and their investment managers. The Act not only mandates registration for many investment managers of private investment funds, it also seeks to limit the "retailization" of private investment funds by increasing the net worth requirements for investors in these funds. In addition, the Act imposes new recordkeeping and reporting requirements on investment managers to private investment funds to ensure that the Securities and Exchange Commission ("SEC") and the newly established Financial Stability Oversight Council (the "Oversight Council") receive information needed to properly regulate private investment funds and manage systemic risk to the financial system. Finally, the Act limits the ability of banks and their affiliates to sponsor and invest in private investment funds and requires the SEC to conduct a number of important studies over the next three years, which may lead to future regulation or legislative action. The Act is of major significance to private investment funds and their investment managers. The Act greatly expands the SEC's authority to regulate investment managers to private investment funds, and accordingly is only the first step in what is likely to be an ongoing and increasing regulatory presence in the private investment fund industry.

Registration of Private Fund Investment Advisers

Title IV of the Act - entitled "Regulation of Advisers to Hedge Funds and Others"[1] - eliminates the "private adviser" exemption from registration under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The "private adviser" exemption, formerly contained in Section 203(b)(3) of the Advisers Act, generally exempted from SEC registration any investment adviser that, in the course of the preceding twelve months, (i) had fewer than 15 clients and (ii) did not hold itself out to the public as an investment adviser or act as an investment adviser to any registered investment company or business development company.

Under the Act, an investment adviser that currently relies on the "private adviser" exemption will soon be required to register with the SEC or state (depending on its assets under management as discussed below), unless the investment adviser qualifies for another existing or a newly created exemption under the Advisers Act.

New Exemptions from SEC Registration

- An investment adviser that has less than $150 million in assets under management ("AUM") in the United States and only advises "Private Funds".[2]
    - The term "Private Funds" is defined as issuers of securities that would be investment companies under the Investment Company Act of 1940, as amended (the "1940 Act"), but for the exception contained in Section 3(c)(1) or Section 3(c)(7) of the 1940 Act.
- An investment adviser that only advises "venture capital funds" (which the SEC is required to define within a year of the Enactment Date.)[3]
- An investment adviser that is a "foreign private adviser". A "foreign private adviser" is defined as an investment adviser that:
    - does not have a place of business in the United States;
    - has, in the aggregate, fewer than 15 clients and investors in the United States in any Private Funds it advises;
    - has aggregate AUM attributable to U.S. clients and to U.S. investors in any Private Funds it advises of less than $25 million or such higher amount as the SEC may, by rule, deem appropriate;[4] and
    - does not hold itself out generally to the public in the United States as an investment adviser, or act as an investment adviser to any registered investment company or business development company.
- An investment adviser that is not a business development company (as defined in the 1940 Act) and only advises certain license-holders (or applicants for a license) under the Small Business Investment Act of 1958.
- An investment adviser that is a "family office" (which the SEC is required to define in a manner consistent with current SEC exemptive orders and in light of the range of organizational, management and employment structures that family offices employ).[5]

In addition, the Act significantly narrows the exemptions from registration contained in (i) Section 203(b)(1) of the Advisers Act (which generally exempts from SEC registration intrastate advisers) to expressly exclude investment managers that advise Private Funds, and (ii) Section 203(b)(6) of the Advisers Act (which generally exempts from SEC registration advisers registered with the Commodities Futures Trading Commission ("CFTC") as commodity trading advisers) to limit that exception to advisers who do not "predominately" provide securities-related advice.

Under the Act, the SEC is required to take into account the size, governance and investment strategy of Private Funds when prescribing regulations to carry out the registration and examination requirements of an investment manager that advises mid-sized Private Funds.

The Act also increases the role of the States in overseeing and regulating the activities of investment advisers by requiring smaller advisers to register at the State level rather than with the SEC. The Act

provides that an investment adviser located in the United States with assets under management of between $25 million and $100 million cannot register with the SEC if it is required to register with the State in which it has its principal place of business and is subject to examination by that state.[6] The Act provides exceptions, thus permitting SEC registration, for investment advisers that (i) advise a registered investment company or a business development company, or (ii) are required to register in fifteen or more U.S. states.

Transition Period. The new investment adviser registration requirements under the Act take effect one year after the Enactment Date (i.e., by July 20, 2011). Investment managers that advise Private Funds may elect to register voluntarily with the SEC during the one-year transition period.

Changes to Definition of "Accredited Investor" and "Qualified Client"

The Act amends, **with immediate effect**, the criteria for a natural person to qualify as an "Accredited Investor" as defined in Regulation D under the Securities Act of 1933, as amended (the "Securities Act"). Under the "Accredited Investor" definition, a natural person qualifies as an "Accredited Investor" if that person, either individually or jointly with that person's spouse, has a net worth of over $1 million. Prior to the adoption of the Act, the value of a person's primary residence had been included in calculating net worth for purposes of this test. The Act effectively increases this net worth threshold by excluding the value of a natural person's primary residence from the net worth calculation. **This change became effective on July 21, 2010, and private fund managers should take prompt steps to amend fund subscription and disclosure documents accordingly. Note that the new criteria apply to any investment in a private fund, whether by a new investor or, we believe, an existing investor making an additional investment.** The Act further provides that after four years from the Enactment Date, the SEC may, through notice and comment rule-making, adjust or modify the net worth calculation rules for natural persons. Further, the SEC must also review the definition of "Accredited Investor" every four years to determine whether the definition should be adjusted or modified.

The Act also provides the SEC with authority to amend by rulemaking the criteria for a person to qualify as a "Qualified Client" as defined in Rule 203A-3(a)(3) under the Advisers Act (i.e., the "performance fee" rule). Under the current definition, a "Qualified Client" includes a person who has a net worth, either individually or jointly with that person's spouse, of more than $1.5 million, or who has at least $750,000 of assets under management with the investment adviser. The Act requires the SEC to adjust these dollar-amount thresholds for inflation within one year of the Enactment Date, and every five years thereafter.

Transition Period. As noted above, the new calculation of the net worth threshold in the definition of "Accredited Investors" under Regulation D is effective immediately.

Recordkeeping and Reporting Requirements for Private Fund Advisers

The Act includes a mandate for the SEC to issue regulations that would impose additional recordkeeping and reporting requirements on SEC-registered investment advisers with respect to the Private Funds they advise. Importantly, while the specific recordkeeping and reporting requirements set forth below apply only to SEC registered advisers, the SEC is empowered to adopt future rules to require recordkeeping and reporting by non-registered Private Fund managers with assets under management of less than $150 million and advisers to venture capital funds (as defined by the SEC) "as it may deem necessary or appropriate". Under the Act, registered investment advisers are

required to maintain and make available to the Oversight Council records of, and file reports with the SEC regarding, each Private Fund it advises (the "Private Fund Information") with respect to the following information:

- The amount of assets under management and use of leverage (including off-balance sheet leverage);
- Counterparty credit risk exposure;
- Trading and investment positions;
- Valuation policies and practices of the funds;
- Types of assets held;
- Side arrangements or side letters;
- Trading practices; and
- Other information that the SEC determines, in consultation with the Oversight Council, to be necessary and appropriate in the public interest and the protection of investors or for the assessment of systemic risk.

The Private Fund Information required to be maintained by an investment adviser or reported to the SEC will be subject to periodic inspections or special examinations by the SEC. The SEC is permitted under the Act to vary the reporting requirements of an investment adviser in accordance with the type or size of the Private Funds it advises.

Transition Period. Under the Act, the SEC is required to issue rules with respect to the new recordkeeping and reporting requirements within one year of the Enactment Date (i.e., by July 20, 2011).

Information Sharing and Confidentiality

The Act requires the SEC to share any Private Fund Information filed with, or provided to it under the Advisers Act, with the Oversight Council and other federal departments, agencies or self-regulatory organizations. The SEC may not withhold any Private Fund Information from Congress, and must comply with any proper requests for Private Fund Information made by other U.S. federal departments, agencies, or self-regulatory organizations. The Act requires the Oversight Council or other recipient of such information to keep such information confidential, and specifically exempts the Oversight Council, the SEC, and any other recipients of Private Fund Information from requests for such information made pursuant to the Freedom of Information Act.

Limitation on Banking Entities' Investment in, or Sponsoring of, Certain Private Funds

Under the Act, bank holding companies, insured banking institutions, any company that controls an insured banking institution, and their affiliates and subsidiaries (collectively, "Banking Entities") are generally prohibited from sponsoring or investing in Private Funds, with certain exceptions discussed below. This prohibition is part of what is commonly referred to as the "Volcker Rule". The term "sponsor" is defined broadly to include (i) serving as the general partner, managing member or

trustee of a Private Fund, (ii) selecting or controlling, in any manner, a majority of the directors, trustees or management of a Private Fund (iii) or sharing the same name or variation thereof, with any Private Fund. For purposes of this prohibition, the term "Private Funds" covers entities that rely on Section 3(c)(1) or Section 3(c)(7) of the 1940 Act to avoid registering as an investment company. However, the Act also authorizes the Federal banking agencies, the SEC and the CFTC to coordinate to adopt rules to expand the definition of "Private Funds" to include other entities.

While this feature of the Volcker Rule generally prohibits Banking Entities from sponsoring or investing in Private Funds, the Act includes an important exception that permits Banking Entities to organize and offer or sponsor Private Funds. To engage in these activities, the following conditions must be satisfied:

- the sponsoring Banking Entity provides bona fide trust, fiduciary or investment advisory services and the fund is organized and offered in connection with the provision of such services;
- the fund is offered only to customers of the Banking Entity that receive bona fide trust, fiduciary or investment advisory services from the Banking Entity;
- the Banking Entity neither directly nor indirectly guarantees, assumes or insures the obligations or performance of the Private Fund;
- the Banking Entity does not engage in certain affiliated transactions with the Private Fund, including, but not limited to, a loan or extension of credit, a purchase of or an investment in securities or a purchase of assets;
- the Banking Entity discloses to prospective and actual investors, in writing, that any losses of the Private Fund are borne by the investors and not the Banking Entity;
- the Private Fund does not use a same or similar name as the Banking Entity;
- No director or employee of the Banking Entity retains an ownership interest in the Private Fund unless they provide investment advisory or other services to the Private Fund;
- the Banking Entity complies with any other rules or regulations promulgated by the U.S. Federal banking agencies, SEC or CFTC; and
- the Banking Entity does not hold an ownership interest in the Private Fund, other than a "de minimis" investment;
    - A "de minimis" investment includes a Banking Entity's seed investment and any other investment in a Private Fund, provided that a Banking Entity (i) actively seeks unaffiliated investors to reduce or dilute its investment in the Private Fund; (ii) reduces its investment in the Private Fund to three percent or less of the private Fund's total ownership interest within one year after establishment and (iii) the investment is immaterial to the Banking Entity, but in no case may the aggregate interests of the Banking Entity in all Private Funds exceed three percent of its Tier 1 capital.[7]

In addition, the Volcker Rule does not apply to Banking Entity's investing in or sponsoring hedge funds or private equity funds that occur solely outside the United States as long as (i) no ownership interest in such funds is offered to U.S. residents, and (ii) the Banking Entity is not directly or indirectly controlled by another Banking Entity that is organized under the laws of the United States or a U.S. state).

Under the Act, the Federal banking agencies, the SEC, the CFTC and the Board of Governors of the Federal Reserve System (the "Fed") will coordinate to adopt a rule subjecting non-banking financial institutions that are regulated by the Fed and either engage in proprietary trading or sponsor or invest in Private Funds to additional capital requirements and additional quantitative limits on such investment activities.

Study and Rule-making Period. Following a study by the Oversight Council, which is required to be completed within six months after the Enactment Date (i.e., by January 20, 2011), the Oversight Council may make recommendations to redefine the types of investments or investment activities prohibited under the Act, or impose additional capital requirements on investment activities. Within nine months after completion of the Oversight Council's study, the U.S. federal banking agencies, SEC and CFTC must jointly implement final regulations reflecting the Oversight Council's recommendations.

Transition Period. The Private Funds prohibition provisions will become effective upon the earlier of one year after the issuance of final rules (as discussed above) or two years after the Enactment Date (i.e., July 20, 2012). Banking Entities must comply with the prohibitions and restrictions within two years after it becomes effective. During this two-year compliance period, the U.S. federal banking agencies, SEC and CFTC are required to impose additional capital requirements and other appropriate restrictions on Banking Entities that sponsor and/or invest in Private Funds. The Fed may extend this two-year transition period for up to three one-year extension periods. In addition, to the extent necessary to satisfy a contractual obligation that was in effect on May 1, 2010, the Fed may grant a Banking Entity, upon application, an extension for compliance with the prohibition provisions. Such an extension may not exceed five years.

Studies Authorized

The Act requires various U.S. federal agencies to conduct studies relating to investment advisers and Private Funds, including:

- A study by the SEC on the need for enhanced examination and enforcement resources for investment advisers (report to Congress due not later than 180 days after the Enactment Date);
- A study by the SEC on the effectiveness of existing standards of care for brokers, dealers and investment advisers, and their associated persons (report to Congress due not later than six months after the Enactment Date);
- A study by the U.S. Comptroller General on the feasibility of forming a self-regulatory organization to oversee Private Funds (report to Congress due not later than one year after the Enactment Date);
- A study by the U.S. Comptroller General on the impact of authorizing a private right of action against any person who aids or abets another in violating federal securities laws (report to Congress due not later than one year after the Enactment Date);

- A study by the SEC, including solicitation for public comment, on extending private rights of action to securities transactions outside the United States and involving only foreign investors (report to Congress due not later than 18 months after the Enactment Date);
- A study by the SEC on the state of short selling on national exchanges and OTC markets with a particular emphasis on failed or late deliveries and the feasibility of requiring real-time reporting (report to Congress due not later than two years after the Enactment Date);
- A study by the SEC on the existing financial literacy of retail investors and methods to improve education and transparency with respect to investment intermediaries, products and services (report to Congress due not later than two years after the Enactment Date);
- A study by the U.S. Comptroller General on the appropriate financial criteria for determining qualification as an "Accredited Investor" and eligibility to invest in Private Funds (report to Congress due not later than three years after the Enactment Date);
- A study by the U.S. Comptroller General on the compliance costs associated with the custody rules applicable to investment advisers (report to Congress due not later than three years after the Enactment Date); and
- A study by the SEC, including recommendations, on ways to improve the access of investors to information about registered investment advisers, brokers, dealers, and their associated persons (including disciplinary actions and proceedings), with implementation of any recommendations not later than 18 months after the Enactment Date.

To view other thought leadership pieces on how this landmark legislation and the myriads of implementing regulations will affect your industry, please follow this link.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Siobhan Burke
213-683-6282
siobhanburke@paulhastings.com

Robert Carlson
213-683-6220
robcarlson@paulhastings.com

Art Zwickel
213-683-6161
artzwickel@paulhastings.com

San Francisco

Mitchell E. Nichter
415-856-7009
mitchellnichter@paulhastings.com

New York

Lawrence J. Hass
212-318-6401
larryhass@paulhastings.com

Domenick Pugliese
212-318-6295
domenickpugliese@paulhastings.com

Thomas Rao
212-318-6838
thomasrao@paulhastings.com

Michael Rosella
212-318-6800
MikeRosella@paulhastings.com

Joshua H. Sternoff
212-318-6011
joshsternoff@paulhastings.com

Washington, D.C.

V. Gerard Comizio
202-551-1272
vgerardcomizio@paulhastings.com

Lawrence D. Kaplan
202-551-1829
lawrencekaplan@paulhastings.com

Kevin L. Petrasic
202-551-1896
kevinpetrasic@paulhastings.com

---

[1] Title IV may also be cited as the "Private Investment Advisers Registration Act of 2010".

[2] Notwithstanding this new "small private fund adviser" exemption, the Act authorizes the SEC to adopt rules imposing recordkeeping and reporting requirements on such advisers.

[3] Notwithstanding this new "venture capital adviser" exemption, the Act authorizes the SEC to adopt rules imposing recordkeeping and reporting requirements on such advisers. The Act does not include an exemption for advisers to private equity funds, which was included in previous versions of the related bills.

[4] The Act does not specify whether the 15 U.S. client/investor limit or the $25 million U.S. AUM limit is calculated over a certain period of time, such as the rolling-12 month basis in the current "private adviser" exemption.

[5] Accordingly, family offices will not be subject to the recordkeeping requirements of the Advisers Act. However, certain family offices that existed prior to January 1, 2010 will continue to be subject to the anti-fraud requirements in Sections 206(1), 206(2) and 206(4) of the Advisers Act. Non-grandfathered family offices will not be subject to the Adviser Act's anti-fraud requirements.

[6] The SEC may increase the $100 million AUM threshold by rule. An investment adviser with assets under management of less than $25 million continues to be prohibited from registering with the SEC unless it advises registered investment companies, has its principal place of business in a U.S. state with no investment adviser regulations, is a pension consultant under Section 203A-2(b) of the Advisers Act or has received an SEC order exempting it from the prohibition against SEC registration.

[7] There is some question as to whether the Act will permit investment by banking entities in funds outside of the "bona fide trust, fiduciary or investment advisory service" context as long as they comply with the 3% de minimus tests. We will need to await adoption of the final regulations for clarity on this point.