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REGULATION OF ADVISERS TO PRIVATE FUNDS AND OTHER CHANGES TO REGULATION OF INVESTMENT ADVISERS UNDER THE FINANCIAL REFORM BILL

On July 15, 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), which President Obama signed into law on July 21, 2010. The Act institutes a broad overhaul of the laws and regulations governing public corporations, financial institutions and other entities dealing in investments and financial instruments. One of the Act's main goals is increasing transparency, accountability and stability within the financial system. To that end, the Act establishes new registration rules for advisers to private funds and makes other changes to the regulation of investment advisers under the Investment Advisers Act of 1940 (the Advisers Act). This e-alert summarizes the key provisions relating to those new rules. Unless otherwise specified, all provisions of the Act relating to private fund advisers are effective one year after enactment of the Act (*i.e.*, July 21, 2011).

Registration of Advisers to Private Funds

Most advisers to private funds¹, such as hedge funds, private equity funds and venture capital funds, meet the definition of an investment adviser under the Advisers Act. However, many advisers to private funds rely on the "private adviser" exemption from registration in Section 203(b)(3) of the Advisers Act for an adviser with fewer than 15 clients that does not hold itself out generally to the public as an investment adviser. Each fund generally only counts as one client for an adviser. The Act eliminates the private adviser exemption, and as a result, an adviser to a private fund will need to register with the SEC unless another exemption applies.²

Exemptions from Registration

The Act creates a number of new exemptions from registration for investment advisers, including a couple expressly designed for private fund advisers.

Venture Capital Fund Advisers. An adviser solely to one or more venture capital funds is exempted from the registration requirements of the Advisers Act. However, the SEC must require venture capital fund advisers to maintain such records and submit such reports as the SEC determines is necessary for the protection of investors. The SEC is directed to issue rules defining the term "venture capital fund" within one year after enactment of the Act. There is no similar exemption for advisers to private equity funds, as had been included in an earlier version of the bill.

¹The Act defines a private fund as any issuer that would be an investment company under the Investment Company Act of 1940 but for the exclusion in Section 3(c)(1) of the Investment Company Act (an issuer with 100 or fewer beneficial owners of its outstanding voting securities which has not made a public offering of its securities) or Section 3(c)(7) of the Investment Company Act (an issuer, all of the outstanding securities of which are owned by qualified purchasers which has not made a public offering of its securities.)

²The Act also excludes an adviser to a private fund from relying on the exemption for intrastate advisers in Section 203(b)(1) of the Act.

Small and Mid-Sized Private Fund Advisers. The Act directs the SEC to exempt from registration under the Advisers Act any investment adviser that acts solely as an investment adviser to private funds and has assets under management in the United States of less than \$150 million. However, the SEC is specifically authorized to require reporting by such exempted advisers and to impose registration and examination procedures on "mid-sized" private fund advisers that reflect the level of systemic risk posed by such funds. The Act does not define a "mid-sized" private fund, although presumably it will be some subset of the category of private fund advisers exempted with less than \$150 million of assets under management.

Foreign Private Advisers. The Act creates an exemption from registration for foreign private advisers. A foreign private adviser is defined as an investment adviser that (1) has no place of business in the United States, (2) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the adviser, (3) 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 (or such higher amount as the SEC may determine by rule), and (4) neither holds itself out generally to the public as an investment adviser nor acts as an adviser to any investment company registered under the Investment Company Act of 1940 or any business development company.

Advisers to Small Business Investment Companies. The Act provides an exemption from registration under the Advisers Act for advisers who solely advise small business investment companies that are licensed by the Small Business Administration.

Family Offices. The Act provides an exemption from the definition of an "investment adviser" for a "family office." The Act does not define a "family office," and instead directs the SEC to adopt a definition in a manner consistent with regulatory relief granted in the past. Over the years, the SEC has provided relief on a case-by-case basis from the limit of 15 clients in the private adviser exemption for advisers who provide services to a single family and a limited number of closely related persons.

Registered CTAs. The Act adds a new exemption for an adviser that is registered with the Commodity Futures Trading Commission (CFTC) as a commodity trading advisor (CTA) and advises a private fund, unless the business of the adviser becomes predominantly the provision of securities-related advice. This exemption is in addition to the existing exemption for a CTA registered with the CFTC whose business "does not consist primarily" of acting as an investment adviser, as defined in the Advisers Act.

Record-Keeping and Reporting

The Act requires private fund advisers registered with the SEC to maintain records regarding: (1) the amount of assets under management and the fund's use of leverage, (2) counterparty credit risk exposure, (3) trading and investment positions, (4) valuation policies and practices, (5) types of assets held, (6) side arrangements giving certain fund investors advantages over others, (7) trading practices, and (8) other information that the SEC determines is necessary for the protection of investors and the assessment of systemic risk.

The Act also directs the SEC to issue rules requiring private fund advisers to file reports containing such information as the SEC deems necessary for the protection of investors and the assessment of systemic risk. Notably, these record-keeping and reporting requirements apply to all private fund advisers, including private fund advisers managing less than \$150 million in assets (and therefore exempted from registering with the SEC). The SEC is directed to take into account the size, governance and investment strategies of mid-sized private funds when determining the record-keeping and reporting requirement applicable to advisers to mid-sized funds.

The Act also addresses the confidentiality of any reports disclosed to the SEC and protects the information from disclosure subject to certain exceptions including requests for information by Congress and other federal agencies.

Additional State Regulation of Investment Advisers

The Act raises the asset threshold for federal registration of investment advisers from \$30 million to \$100 million (currently, an adviser with more than \$25 million but less than \$30 million of assets under management may register either with the SEC or the states in which it operates). An investment adviser managing less than \$100 million in assets will be subject exclusively to the supervision of the state or states in which it operates; provided, however, that an investment adviser managing less than \$100 million in assets that would be required to register with 15 or more states may elect to register with the SEC. The Act is not clear as to what happens to advisers currently registered with the SEC with more than \$25 million but less than \$100 million of assets under management.

Indexing the Qualified Client Standard to Inflation

Section 205(a) of the Advisers Act generally prohibits an investment adviser that is registered with the SEC from charging a client performance-based compensation, such as an incentive allocation or carried interest typically charged by an adviser, to a private fund. However, Rule 205-3 under the Advisers Act permits performance-based compensation to be charged to any client who is a "qualified client." A "qualified client" currently includes a natural person who has at least \$750,000 under the management of the investment adviser, a natural person or entity that has a net worth of more than \$1.5 million and a "qualified purchaser" as defined in the Investment Company Act of 1940. The Act requires the SEC, no later than one year after enactment of the Act and every five years thereafter, to adjust any dollar amount used for the determination of a qualified client for the effects of inflation. It is not clear whether initial indexing by the SEC will take account of the cumulative effect of inflation since the qualified client standard was originally adopted or whether current arrangements with persons who are qualified clients will be grandfathered.

SEC Authority to Restrict Arbitration

Investment advisers (as well as broker-dealers and other securities professionals) frequently include mandatory arbitration clauses in client contracts. The Act specifically authorizes the SEC to prohibit or restrict such arbitration clauses.

SEC Rulemaking

As noted above, the provisions regarding advisers to private funds do not take effect until 2011. In the meantime, much of the details of the application of the provisions will need to be determined through SEC rulemaking, including the scope of exemption for advisers to venture capital funds and the requirements applicable to advisers to funds with less than \$150 million of assets under management. Future e-alerts will cover the SEC rules addressing these provisions as they are adopted.

If you have any questions or concerns regarding the issues discussed in this e-alert, please contact your Reinhart attorney or an attorney with Reinhart's securities team.

This *Reinhart Headlines in Securities Law E-Alert* provides general information and should not be construed as legal advice or a legal opinion. Readers should seek legal counsel concerning specific factual situations confronting them.

