Private Fund Investment Advisers

Title IV of the Dodd-Frank Act provides for a number of changes to the regulatory regime governing investment advisers and private funds. Among other effects, the Act will require many currently unregistered investment advisers to register with the SEC pursuant to the Investment Advisers Act of 1940, as amended (the “Advisers Act”), by removing a commonly used exemption from registration under the Advisers Act. The Act also will impose increased recordkeeping and reporting obligations on investment advisers to certain private funds. Additionally, the “Volcker Rule” contained in the Act will limit the ability of banking entities and nonbank financial companies supervised by the Board of Governors to sponsor or invest in private funds, including hedge funds and private equity funds.

Enhanced Registration Requirements for Advisers to Private Funds

Currently, many investment advisers are not registered with the SEC, instead relying on various exemptions to registration granted pursuant to the Advisers Act. One of the more commonly used exemptions to registration is the “private adviser exemption,” which is available to investment advisers with fewer than 15 clients, among other criteria. The Act eliminates the private adviser exemption, which will have the effect of requiring a large number of currently unregistered advisers to register with the SEC.

Exclusions and Exemptions to Registration Requirements for Advisers to Private Funds

Despite the elimination of the private adviser exemption, the Act provides for several new exemptions to the registration requirements for private fund advisers, which are summarized below.

Mid-Sized Private Fund Advisers. The Act requires that the SEC provide an exemption from the registration requirements for investment advisers with less than $150 million in assets under management. This $150 million exemption, however, applies only to investment advisers who act solely as advisers to private funds and have assets under management in the United States of less than $150 million. Nevertheless, the Act requires that investment advisers who take advantage of this exemption maintain such records and provide such annual reports to the SEC as the SEC by rulemaking shall determine are necessary and appropriate in the public interest or for the protection of investors. The Act also grants the SEC the authority to propose registration and examination procedures for investment advisers to “mid-sized private funds,” taking into account the size, governance, investment strategy and level of systemic risk posed by such funds. This authority will allow, but not require, the SEC to carve out full or partial exemptions for categories of mid-sized private funds beyond the exemption levels that are expressly provided for in the Act.

A private fund adviser that utilizes this exemption will need to determine in what states it is required to register as an investment adviser. Such an adviser may in fact be required to register in a number of different states, depending on where it conducts its business.

1 The private adviser exemption contained in Section 203(b)(3) of the Advisers Act exempts from registration an investment adviser that (i) had fewer than 15 clients during the preceding 12 months, (ii) does not hold itself out to the public as an investment adviser, and (iii) does not serve as an investment adviser to a registered investment company or a business development company.
2 Act § 403.
3 Act § 408.
4 A private fund is an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, as amended (the “1940 Act”), but for section 3(c)(1) or 3(c)(7) of the 1940 Act.
5 Act § 408.
Venture Capital Funds. The Act exempts venture capital fund advisers from registration under the Advisers Act. To qualify for the exemption, an adviser must act as an investment adviser solely to one or more venture capital funds. Although the Act exempts such advisers from registration, it permits the SEC to subject venture capital fund advisers to reporting and recordkeeping requirements as the SEC determines necessary or appropriate in the public interest or for the protection of investors.  

The SEC is charged with defining “venture capital fund” within one year after the passage of the Act. The different registration and reporting requirements applicable to “venture capital funds,” and otherwise to “private funds,” will make the SEC’s chosen definition of great interest to investment advisers.

Foreign Private Advisers. The Act exempts from registration any investment adviser that is a “foreign private adviser,” which is defined in the Act as any investment adviser that:

- has no place of business in the United States;
- has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser;
- has aggregate assets under management 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, by rule, deem appropriate; and
- 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 any business development company.

Unless the SEC, by rulemaking, significantly increases the $25 million threshold described above, the Act’s exemption for this purpose is fairly narrow, and will limit the ability of non-U.S. advisers to raise significant funds in the United States without first registering as investment advisers.

Family Offices, Small Business Investment Companies, Commodity Trading Advisers and the Intra-State Exemption. The Act exempts family offices from the definition of investment adviser and directs the SEC to promulgate rules pertaining to the exemption. Further, the Act exempts from registration any investment adviser that is registered with the CFTC as a commodity trading adviser (so long as the business of the adviser does not become predominantly the provision of securities-related advice) or solely advises small business investment companies.

The Act also narrows but does not eliminate the “intra-state exemption.” The current intra-state exemption in the Advisers Act exempts from registration any investment adviser all of whose clients are residents of the state within which such investment adviser maintains its principal office. The Act narrows this exemption by excluding investment advisers to any “private fund” (as defined in the Act).

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6 Act § 407.
7 Id.
8 Act § 403.
9 Act § 409.
10 Act § 403.
11 Act § 403.
Increased Recordkeeping and Reporting Requirements for Advisers to Private Funds

The Act empowers the SEC to create broad recordkeeping and reporting requirements for registered investment advisers to “private funds.” The records that must be maintained by such an investment adviser, made available for SEC inspection, and possibly subject to future SEC filing requirements, include:

- 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 fund;
- types of assets held;
- side arrangements or side letters;
- trading practices; and
- such other information as the SEC, in consultation with the Council, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

Under the Act, the recordkeeping requirements listed above are generally applicable to registered investment advisers to private funds. However, the SEC may establish different reporting standards for different classes of fund advisers, based on the size or type of private fund being advised. Additionally, as described above, venture capital fund advisers and mid-size fund advisers may be subject to different recordkeeping and reporting requirements to be determined by the SEC.

Confidentiality. The Act requires that the SEC share reports and documents filed with it with the Council. Furthermore, the Act provides that neither the SEC nor the Council may be compelled to disclose information received from private funds, and such information is exempt from disclosure pursuant to the Freedom of Information Act (“FOIA”). However, the confidentiality requirement of the Act does not authorize the SEC to withhold information from Congress, or prevent the SEC from complying with a relevant request from any other federal department, agency, or self-regulatory organization or an order of a U.S. court in an action brought by the federal government or the SEC. Any other such recipient is also bound by similar confidentiality provisions and is granted an exemption from the FOIA. The Act also protects from public disclosure any “proprietary information” of the investment adviser received by the

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12 Act § 402 defines the term “private fund” as any issuer that would be an investment company under the 1940 Act, but for Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. Section 3(c)(1) of the 1940 Act generally provides an exemption from registration for an issuer (i) whose securities are owned by not more than 100 persons and (ii) who does not engage or propose to engage in a public offering of securities. Section 3(c)(7) of the 1940 Act generally provides an exemption from registration for an issuer (i) all of whose security holders are “qualified purchasers” (as defined in the 1940 Act) and (ii) who does not engage or propose to engage in a public offering of securities.

13 Act § 404.

14 Id.

15 Id.
SEC to the same extent as facts the SEC ascertains during an examination.\textsuperscript{16} Finally, the SEC will provide an annual report to Congress detailing how the SEC has used this information to monitor the market for the protection of investors and the integrity of the markets.\textsuperscript{17}

**Advisory Client Disclosures.** Prior to the passage of the Act, Section 210(c) of the Advisers Act prevented the SEC from requiring an investment adviser to disclose the identity, investments or affairs of its clients, except as may be necessary or appropriate in a particular enforcement proceeding or investigation under the Advisers Act. The Act creates a new exception to this provision, allowing such disclosure “for purposes of assessment of potential systemic risk.”\textsuperscript{18}

**Possible Effects of the Enhanced Reporting Obligations.** Notwithstanding the confidentiality provisions of the Act, the new recordkeeping and reporting requirements may give the SEC and other government agencies access to highly detailed and confidential information regarding a private fund’s positions, trading strategies, side letters and advisory clients. This heightens the risk of accidental disclosure of confidential information.

**Asset Threshold for SEC Registration**

An investment adviser may register with the SEC if it has assets under management of at least $25 million. However, as part of the Act’s increased reliance on state regulators instead of the SEC for the regulation of mid-sized investment advisers, the Act requires that investment advisers register with state regulators (and not the SEC) if the investment adviser would be subject to examination by the state regulators and the investment adviser has between $25 million and $100 million in assets under management.\textsuperscript{19} An investment adviser that meets these two criteria may still register with the SEC if the investment adviser (a) serves as investment adviser to a registered investment company, (b) serves as investment adviser to a business development company, or (c) would otherwise be required to register in 15 or more separate states.\textsuperscript{20}

Coupled with the elimination of the “private adviser exemption” described above, the “higher assets under management” threshold will delegate regulation of many mid-sized investment advisers to the various states. As a result, advisers that are not permitted to register with the SEC may be subject to varied and potentially contradictory state “Blue Sky” laws governing investment adviser registration, while allowing the SEC to focus on the regulation of larger investment advisers.

\textsuperscript{16}Id. “Proprietary information” is defined in the Act to include sensitive, non-public information regarding (i) the investment or trading strategies of the investment adviser, (ii) analytical or research methodologies, (iii) trading data, (iv) computer hardware or software containing intellectual property and (v) any additional information that the SEC determines to be proprietary.

\textsuperscript{17}Act § 404.

\textsuperscript{18}Act § 405.

\textsuperscript{19}Act § 410.

\textsuperscript{20}Id.
Transition Period

The Act provides for a one-year transition period from the date of enactment before the provisions of the relevant legislation become effective, except as otherwise provided. During that period, the SEC will promulgate rules and regulations regarding the various new standards coming into place. Investment advisers to private funds may, at the adviser’s discretion, register with the SEC during the one-year transition period subject to the SEC’s rules.

Enhanced Role of the Federal Reserve

The Federal Reserve’s role will be greatly expanded under the Act. The following discussion summarizes certain areas in which the Federal Reserve’s new powers and duties may affect investment advisers.

Systemic Risk Regulation. Under the Act, the Federal Reserve will have the ability to extend its regulatory powers to cover financial institutions that potentially pose a threat to the financial stability of the United States. This may come to include private funds under the newly defined term “nonbank financial company.” The Act defines a “nonbank financial company” generally as a company predominantly engaged in activities that are financial in nature. The Council is granted the authority to determine which nonbank financial companies potentially pose a threat, and has the ability to subject such a company to regulation by the Federal Reserve, including regulation of capital amounts, leverage and liquidity. Non-U.S. financial companies are generally included in the definition of “nonbank financial companies” to the extent of their U.S. activities.

It is possible that the enhanced regulatory powers of the Federal Reserve pursuant to the Act could be used to regulate large private funds, especially highly-leveraged hedge funds. See “Key Measures to Address Systemic Risk.”

Limitation of Bank Ownership or Sponsorship of Private Funds — The “Volcker Rule”

Along with the Federal Reserve’s expanded powers summarized above, the Act includes the so-called “Volcker Rule,” which limits the activities of banking entities as well as nonbank financial companies supervised by the Board of Governors pursuant to the powers granted under the Act. The following section focuses on the Volcker Rule’s applicability to private fund investment advisers. For a general discussion of the Volcker Rule, see “The Volcker Rule.”

Under the Volcker Rule, banking entities and nonbank financial companies supervised by the Board of Governors are limited in their ability to sponsor or invest in a hedge fund or a private equity fund. The terms “hedge fund” and “private equity fund” are defined for purposes of this section in the same manner as the term “private fund” is defined in the Act (i.e., any fund that would be an investment company

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21 Act § 419.
22 Id.
23 Act § 102(a)(4).
24 Act § 113(a).
25 Act § 619 (to be codified at 12 U.S.C. § 1851(h)(1)) defines “banking entity” to include insured depository institutions, any company that controls an insured depository institution or is treated as a bank holding company, and affiliates and subsidiaries of any such entities (including private fund managers and broker-dealer subsidiaries).
but for Sections 3(c)(1) or 3(c)(7) of the 1940 Act); however, the appropriate federal agencies, including the SEC, may expand this definition by rule.\textsuperscript{27} In contrast to the term “private fund” for purposes of Title IV, the definition under the Volcker Rule does not include any carve-outs for venture capital funds.

The Volcker Rule generally bans banking entities from sponsorship of or investment in a private fund unless an exception is available.\textsuperscript{28} “Sponsoring” is defined for these purposes as: serving as a managing member, general partner or trustee of a fund; in any manner selecting or controlling a majority of the directors, trustees or management of a fund; or sharing with the fund the same name or a variation of the same name for corporate, marketing, promotional or other purposes.\textsuperscript{29} While nonbank financial companies supervised by the Board of Governors are not subject to an outright ban like banking entities, they will be subject to additional capital requirements and quantitative limits if they do not comply with the same exceptions as banking entities regarding the sponsorship of or investment in a private fund as described below.

**Sponsorship of Private Funds.** A banking entity is permitted to sponsor a private fund if it complies with each of the following criteria:

(i) the banking entity provides bona fide trust, fiduciary or investment advisory services;

(ii) the fund is organized and offered only in connection with the services described in the foregoing paragraph (i) and only to persons that are customers of such services of the banking entity;

(iii) the banking entity does not acquire or retain an equity interest in the private fund except for a de minimis interest (as described below);

(iv) the banking entity does not enter into “covered transactions” as defined in Section 23A of the Federal Reserve Act with the private fund, and the banking entity acts in accordance with Section 23B of the Federal Reserve Act as if such entity was a member bank and such private fund was an affiliate;

(v) the banking entity does not, directly or indirectly, guarantee the obligations or performance of the private fund;

(vi) the banking entity does not share the same name (or a variation thereof) with the private fund;

(vii) no director or employee of the banking entity takes or retains an equity interest in the private fund, except for any such person engaged in providing investment advisory or other services to the private fund; and

(viii) the banking entity discloses to prospective and actual investors in the private fund, in writing, that any losses in the private fund will be borne solely by investors in the fund and not by the banking entity.\textsuperscript{30}

Meeting the criteria listed above will add certain compliance costs to the operations of a typical private fund. In particular, the limitation on bank ownership except for a de minimis interest will reduce, but not

\textsuperscript{27}Act § 619 (to be codified at 12 U.S.C. § 1851(h)(2)).

\textsuperscript{28}Act § 619 (to be codified at 12 U.S.C. § 1851(a)(1)).

\textsuperscript{29}Act § 619 (to be codified at 12 U.S.C. § 1851(h)(5)).

\textsuperscript{30}Act § 619 (to be codified at 12 U.S.C. § 1851(d)(1)(G)).
remove, the ability of banks to invest their own capital side-by-side with third-party investors. Additionally, the de minimis investment limitation may require some private funds to alter their carried interest payment provisions, as carried interest left invested in a fund may, over time, exceed the de minimis investment limit. The de minimis investment limitations are discussed in more detail below.

Similarly, the name restriction described in paragraph (vi) above, the equity interest restriction described in paragraph (vii) above, and the written disclosure requirement described in paragraph (viii) above may require certain changes to existing or contemplated private funds, while the Section 23A and 23B restrictions described in paragraph (iv) above may limit a private fund’s ability to enter into certain transactions. See “The Volcker Rule.”

Finally, banking entities will need answers, through SEC guidance or rulemaking, to significant questions regarding the requirement for bona fide investment advisory services described in paragraphs (i) and (ii) above. Banking entities must be sure to meet those requirements, as well as the requirements described in paragraph (v) above regarding the absence of guarantees of private fund obligations or performance, once the appropriate standards are determined by final regulations.

De Minimis Investments in Private Funds. A banking entity may make investments in a private fund it organizes or offers if the investment does not exceed 3% of the total ownership interests of such private fund and the aggregate of all of the investments made by the banking entity in such private funds does not exceed 3% of the banking entity’s Tier 1 capital. Additionally, banking entities are allowed to exceed the 3% fund ownership limit when providing seed capital to a private fund, provided that the banking entity seek unaffiliated investors and reduce its holdings to meet the 3% total ownership test within one year after the date of the establishment of the fund, whether by redemption, sale, or dilution (with up to a two-year extension at the discretion of the Board of Governors). The “3% of Tier 1 capital” test also may be reduced by a forthcoming rule to ensure that the total investment is “immaterial” to the banking entity.

This “3 and 3” rule is a more favorable standard than the early proposals of the Volcker Rule, which called for significantly more stringent prohibitions on the ability of banking entities to invest in private funds. While the Volcker Rule will limit the ability of banking entities to invest side-by-side with third-party investors, it will not prohibit banking entities from sponsoring and managing hedge funds and private equity funds going forward.

Timing. It may take as long as seven years before the provisions of the Volcker Rule come into effect. This time estimate is reached as follows: The effective date of the Volcker Rule is the earlier of 12 months from the date of the issuance of final rules or two years after the enactment of the Act. Given the complexity of the legislation and the number of different regulatory agencies involved in the process, we expect it will take at least one year for final rules to be issued, so we estimate this effective date to be two years after the enactment of the Act. Following effectiveness, banking entities have two years to come into compliance with the provisions of the Volcker Rule. The Board of Governors may extend this period further by up to three one-year extensions, leading to a total of up to seven years from the enactment of the Act. For illiquid funds, extensions of the effective date of up to five years are available from the Board of Governors on a case-by-case basis.

31 Act § 619 (to be codified at 12 U.S.C. § 1851(d)(4)(B)(ii)).
33 Act § 619 (to be codified at 12 U.S.C. § 1851(d)(4)(B)(ii)(II)).
34 Act § 619 (to be codified at 12 U.S.C. §§ 1851(c)(1) – (3)). For additional detail regarding timing, see “The Volcker Rule.”
Adjustment of Accredited Investor Standard

Immediately upon passage of the Act, the accredited investor standard for natural persons will be revised such that the net worth threshold of $1 million will exclude the value of the investor’s primary residence. The exclusion of the primary residence marks a change from the current net worth threshold. The SEC may review the other provisions of the natural person accredited investor definition (such as the net income test) immediately upon passage of the Act, and may adjust or modify such provisions immediately for the protection of investors, in the public interest and in light of the economy. After the four-year period from the enactment of the Act, and every four years thereafter, the SEC is tasked with reviewing the accredited investor standard and, if appropriate, adjusting such standard for the protection of investors, in the public interest and in light of the economy.

The changes to the accredited investor definition contained in the Act are expected to have a limited impact on Section 3(c)(7) funds, since investors in such funds also must meet the generally higher qualified purchaser standard under the 1940 Act. Furthermore, the changes to the accredited investor standard apply to all private placements under Regulation D, not just offerings made by private funds. As such, the impact of the new rules will be felt well beyond the private fund sphere.

Custody of Client Assets and Accounts

The Act adds to the Advisers Act a specific requirement that registered investment advisers who have custody of client assets must take such steps to safeguard client assets as the SEC may prescribe, including, without limitation, having such assets verified by an independent public accountant. Further, the Act directs the Comptroller General of the United States to conduct a study of the compliance costs associated with the custody rules and submit a report on the results of the study to Congress within three years of the enactment of the Act.

Adjustment of the Qualified Client Standard for Inflation

Generally, investment advisers required to be registered may only charge a carried interest or performance fee or allocation to investors who meet the qualified client standard. The Act requires the SEC to adjust for inflation any dollar-amount tests used to determine the qualified client standard. The first such adjustment must occur within one year of the enactment of the Act, and subsequent adjustments will occur every five years thereafter. Any such adjustment will be rounded to the nearest multiple of $100,000. Like the change to the accredited investor standard, this increase is expected to have a limited impact on Section 3(c)(7) funds since investors in such funds must meet the generally higher qualified purchaser standard.

35 Act § 413(a).
36 Act § 413(b).
37 Act § 411.
38 Act § 412.
39 Act § 418 (to be codified at 15 U.S.C. § 80b-5(e)).