Client Advisory

Katten
KattenMuchinRosenman LLP

Financial Services

July 29, 2010

Financial Reform Bill Reshapes Investment Adviser Regulation

The Private Fund Investment Advisers Registration Act of 2010 (the Act), signed into law on July 21, markedly changes who will be required, and who will be permitted, to register as investment advisers with the Securities and Exchange Commission (SEC). The Act, which is part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), also provides various new exemptions and mandates numerous studies. This Client Advisory summarizes some of the central provisions of the Act:

- Elimination of small/private adviser exemption, resulting in required registration for many private fund managers
- $100 million threshold for SEC registration of advisers managing accounts and private funds
- Permissive SEC registration for certain multi-state advisers with $25 million to $100 million of assets
- Exemption to be adopted for advisers managing only private funds with less than $150 million under management in the United States
- Exemption for "foreign private advisers"
- Various other exemptions—advisers to venture capital funds, family offices, SBICs and CTAs
- Changes to client/investor standards
- Recordkeeping and reporting requirements
- Mandate for studies

Because Congress vested significant discretion in the SEC to promulgate rules to implement the Act, its full impact will not be known for some time. In a departure from previous process, the SEC is now seeking public comment on regulatory initiatives mandated by Dodd-Frank prior to issuing rule proposals. Comments may be submitted through topic-specific mailboxes on the SEC website at http://www.sec.gov/spotlight/regreformcomments.shtml.

The following is a synopsis of the main provisions of the Act and certain issues raised that remain to be addressed through rulemaking.

Elimination of Small/Private Adviser Exemption

The Act eliminates the exemption from registration under Section 203(b)(3) of the Investment Advisers Act of 1940, as amended, (the Advisers Act) for investment advisers who (i) have had fewer than 15 clients in the preceding 12 months; (ii) do not generally

If you would like to discuss the Act and its implications for your business, please contact your Katten Muchin Rosenman LLP attorney or any of the following members of the Financial Services Practice:

Henry Bregstein
212.940.6615 / henry.bregstein@kattenlaw.com

Wendy E. Cohen
212.940.3846 / wendy.cohen@kattenlaw.com

Daren R. Domina
212.940.6517 / daren.domina@kattenlaw.com

Jack P. Governale
212.940.8525 / jack.governale@kattenlaw.com

Ricardo J. Hollingsworth
212.940.6482 / ricardo.hollingsworth@kattenlaw.com

Joseph Iskowitz
212.940.6351 / joseph.iskowitz@kattenlaw.com

Kathleen H. Moriarty
212.940.6304 / kathleen.moriarty@kattenlaw.com

Marilyn Selby Okoshi
212.940.8512 / marilyn.okoshi@kattenlaw.com

Fred M. Santo
212.940.8720 / fred.santo@kattenlaw.com

Peter J. Shea
212.940.6447 / peter.shea@kattenlaw.com

Marybeth Sorady
202.625.3727 / marybeth.sorady@kattenlaw.com

Robert Weiss
212.940.8584 / robert.weiss@kattenlaw.com

Meryl E. Wiener
212.940.8542 / meryl.wiener@kattenlaw.com

Allison Yacker
212.940.6328 / allison.yacker@kattenlaw.com

Lance A. Zinman
312.902.5212 / lance.zinman@kattenlaw.com

www.kattenlaw.com

hold themselves out to the public as investment advisers; and (iii) do not act as advisers to registered investment companies or business development companies. The repeal of this exemption affects many hedge fund, private equity fund and real estate managers, leaving them without the exemption on which they have previously relied to avoid registration as investment advisers. Many fund managers, including certain foreign advisers with U.S. clients, may be required to register for the first time.

It is unclear what the effect of the legislation on state law will be, or how some state laws will apply. Many states have a registration exemption linked to the repealed Advisers Act Section 203(b)(3). Those states that have such laws must address this or risk creating a gap in the registration of investment advisers not qualified to be federally registered and not currently required to be state registered.

The repeal of Section 203(b)(3) is effective July 21, 2011, and those advisers newly subject to Advisers Act registration must be registered by then. The SEC has recently adopted sweeping changes to Part 2 of Form ADV, the "brochure" required of investment advisers, which will be required to be filed electronically. These changes, which will be addressed in a separate Client Advisory, are effective for new advisers registering after January 1, 2011. It would be prudent for new registrants to await the new form to avoid duplicate efforts, even if they intend to register prior to the effective date of the legislation.

Definition of Private Fund

The primary focus of the Act is to regulate managers to "private funds." The Act defines a "private fund" as an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (the ICA), but for the exclusion in Section 3(c)(1) or 3(c)(7) of the ICA. This encompasses most hedge funds and private equity funds that are either located in the United States or that are located offshore but accept subscriptions from U.S. investors.

$100 Million Threshold for Advisers Managing Accounts and Private Funds

The Act raises the threshold of assets under management required for SEC registration to $100 million. Investment advisers currently registered with the SEC that have assets under management between $25 million and $100 million that will be subject to registration in and examination by the state in which they have their principal places of business will be required to de-register and become regulated by the states. The impact on advisers in states such as New York that do not have examination programs is unclear at this time.

Permissive Registration for Multi-State Advisers with Assets Under Management of between $25 Million and $100 Million

SEC registration would be available to an adviser with assets between the $25 million and $100 million levels if that adviser would be required to register in 15 or more states. This is more permissive than the SEC's current rule permitting multi-state advisers to register with the SEC if they would have to register in 30 or more states.

Intra-state Advisers

The Act eliminates the exemption from registration under Section 203(b)(1) for an intra-state adviser that manages a private fund, although the exemption is still available to other intra-state advisers.

Exemption for Advisers Managing Only Private Funds with Less than $150 Million under Management in the United States

The Act directs the SEC to adopt rules providing an exemption from registration for an adviser that solely manages private funds and has less than $150 million in assets under management in the United States. Such exempted advisers would still be required to maintain certain records and provide reports to the SEC.

The SEC is also directed to provide registration and examination procedures for advisers to "mid-sized private funds," which term is not defined in the Act, taking into account the size, governance and investment strategy of such funds to assess the systemic risk they pose.

Foreign Private Adviser Exemption

Even non-U.S.-based advisers could be required to register if they have U.S. clients and meet the asset threshold, although as discussed below, there may be questions as to the SEC's ability to assert jurisdiction over foreign advisers with a limited nexus to the United States. Presuming that registration would be required, the Act provides a limited exemption from such registration for a "foreign private adviser" that satisfies all of the following requirements: The advisor (1) has no place of business in the United States; (2) has, in total, fewer than 15 U.S. clients and U.S. investors in "private funds" advised by the adviser; (3) has aggregate assets under management attributable to U.S. clients and U.S. investors in "private funds" advised by the adviser of less than $25 million (or such higher amount as the SEC may deem appropriate); and (4) neither (i) holds itself out generally to the U.S. public as an investment adviser, nor (ii) acts as an investment adviser to any registered investment company or business development company.

There remain legal questions, however, about the reach of SEC jurisdiction to require registration of a non-U.S.-based adviser with no direct clients, even if U.S. persons invest in non-U.S. funds they manage. Under the decision of a federal court of appeals in *Goldstein v. SEC,* a fund, and not an investor in a fund, is the client of the foreign adviser for U.S. definitional purposes. Therefore, absent contacts directed into the United States that might confer jurisdiction, a foreign adviser who advises only offshore funds and other clients outside the United States would not fall under the Advisers Act at all. The inclusion in the exemption for foreign private advisers of thresholds for U.S. investors in private funds creates uncertainty as to the applicability of the Act to such advisers. The definition also creates uncertainty as to the continued applicability of prior SEC guidance to international financial institutions under no action letters such as *Uniao Banco de Brasileiros S.A.* and its progeny that allowed such institutions to provide services to U.S. persons through a registered investment adviser without subjecting their non-U.S. operations to SEC registration and oversight.

Various Other Exemptions

Venture Capital Fund Adviser Exemption. The Act provides an exemption from registration for advisers solely to "venture capital funds," with that term to be defined by the SEC by July 21, 2011. Although exempt from registration, these advisers will be required to maintain records and provide to the SEC such annual or other reports as the SEC determines.

Exclusion for Family Offices. The Act excludes "family offices" from the definition of "investment adviser" and thus from Advisers Act registration. It again leaves the term to be defined by the SEC by July 21, 2011, but directs that the rules defining "family office" be consistent with previous SEC exemptive orders and certain grandfathering provisions. The SEC has previously issued exemptive orders to family offices serving the lineal descendants of a single individual, their spouses and entities, including private foundations and charities exclusively owned by or for the benefit of, or created by, such individuals. On a few occasions, the SEC has permitted exempted family offices to allow key executives and employees involved in investment decisions to participate in the family's collective investment vehicles on a limited basis.

Small Business Investment Company Exemption. The Act exempts from Advisers Act registration any investment adviser that solely advises small business investment companies that are licensees under the Small Business Investment Act of 1958 (other than business development companies regulated under the ICA). These investment advisers, however, are not required to maintain records and provide reports to the SEC.

Commodity Trading Advisor (CTA) Exemption. The Act maintains the exemption from Advisers Act registration for any investment adviser that is registered with the Commodity Futures Trading Commission (CFTC) under the Commodity Exchange Act, as amended (the CEA) as a CTA whose business does not consist primarily of acting as an investment adviser as defined in the Advisers Act, but adds that, if the business of the adviser should become "predominately the provision of securities-related advice," then such adviser must register as an investment adviser with the SEC.

Client Eligibility

Adjustments to Accredited Investor Standards. The Act modifies immediately the net worth threshold for individual "accredited investors" and also directs the SEC to review and adjust all "accredited investor" standards in Rule 501 of Regulation D under the Securities Act of 1933, as follows:

- The net worth threshold for individuals will remain $1 million until July 21, 2014, but now excludes the value of the individual's primary residence. The SEC has already clarified that any mortgage on the primary residence may be excluded from calculation as well, except that any amount of mortgage in excess of the fair market value of the residence must be treated as a liability and deducted from net worth.
- The SEC is authorized immediately to review the definition of the term "accredited investor" for natural persons and to promulgate rules adjusting the provisions of the definition that do not relate to the net worth threshold.
- The SEC is required to review the definition of the term "accredited investor" in its entirety as applied to natural persons every four years and to modify the definition as appropriate "for the protection of investors, in the public interest, and in light of the economy."

Adjustments to "Qualified Client" Standard. The Act requires the SEC to adjust for the effect of inflation every five years the dollar amount standards used to determine client eligibility to pay performance fees.

Standard of Conduct for Brokers Providing Personalized Advice. The Act authorizes the SEC to promulgate rules providing that the standard of conduct for brokers, dealers and investment advisers that give personalized investment advice about securities to retail customers, and other customers as provided by SEC rules, shall be "to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice." The Act further provides, however, that any material conflict of interest must be disclosed to and may be consented to by the customer. For these purposes, a "retail customer" is a natural person who receives personalized investment advice and uses that advice for personal, family or household purposes. The SEC is also directed to facilitate the provision of simple and clear disclosures to investors regarding their relationships with brokers, dealers and investment advisers, including material conflicts of interest, and to promulgate rules prohibiting sales practices, conflicts of interest and compensation schemes for brokers, dealers and investment advisers that it deems contrary to the public interest and the protection of investors. This rulemaking authorization is significant, as it represents a change from purely disclosure-based regulation toward a public interest standard, irrespective of meaningful disclosure and informed consent.

The Act also provides for the SEC to conduct a study of these issues in conjunction with its rulemaking. On July 27, the SEC requested public comment for such a study to evaluate the effectiveness of existing legal or regulatory standards of care in connection with personalized advice to retail customers and asked whether there are gaps, shortcomings or overlaps in legal or regulatory standards. See: http://www.sec.gov/rules/other/2010/34-62577.pdf.

Recordkeeping and Reports

Private Fund Records and Reports. The Act requires registered advisers to private funds to maintain records and file reports containing specified information regarding such funds, including: (i) the amount of assets under management 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; (vii) trading practices; and (vii) other information determined to be necessary in the public interest, for the protection of investors or for the assessment of systemic risk. There are provisions requiring confidential treatment of such records and reports. The SEC is required to inspect the records of private funds maintained by an investment adviser, and must provide an annual report to Congress describing how the SEC has used the data collected to monitor the markets for the protection of investors and the integrity of the markets.

Protection of Advisers' Proprietary Information. The Act enhances confidentiality protection with respect to proprietary information provided by investment advisers to the federal government by making information provided under the Act to the SEC not subject to the Freedom of Information Act and providing additional safeguards. The Act defines "proprietary information" 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.

Client Information. The Act adds a further exception to the general rule that client information is confidential, which would enable the SEC to require the disclosure by SEC-registered investment advisers of certain client information "for purposes of assessment of potential systemic risk," as well as in connection with enforcement proceedings and investigations.

Other Significant Provisions

Extraterritorial Application. The Act adds a new provision to the Advisers Act on extraterritorial jurisdiction, giving the U.S. courts jurisdiction over certain conduct occurring outside the United States, but only in a case brought under the antifraud provisions in Section 206 involving such conduct that has a "foreseeable substantial effect" in the United States. The U.S. courts also have antifraud jurisdiction over conduct within the United States that constitutes "significant steps in furtherance of a violation" even if the violation is committed by a foreign adviser and involves only foreign investors. The Act is silent on extraterritorial application of the registration provisions of the Advisers Act.

Custody of Client Assets. The Act allows the SEC to promulgate rules to require registered advisers to take steps to safeguard client assets over which they have custody, including requiring verification of such assets by an independent public accountant. This is legislative underpinning for actions taken by the SEC in amending the custody rule earlier this year.

Definition of "Client." The Act prohibits the SEC from modifying the definition of the term "client" for purposes of Section 206(1) and 206(2) of the Advisers Act, which prohibit fraud against clients and prospective clients, to include investors in a private fund managed by an investment adviser, if such fund has entered into an advisory contract with such adviser. It does not circumscribe the definition of "client" under SEC rules adopted pursuant to Section 203 of the Advisers Act, the registration requirement. The legislation does not overrule the *Goldstein* decision, which held that a private fund, rather than each investor, is the "client."

Rule of Construction Relating to the Commodity Exchange Act. The Act states that nothing in the Advisers Act shall relieve any person of any obligation or duty, or affect the availability of any right or remedy available to the CFTC or any private party arising under the CEA governing commodity pools, commodity pool operators or commodity trading advisors.

Advisers Registered with the CFTC. The Act requires the SEC and the CFTC, after consultation with the Financial Stability Oversight Council, jointly to promulgate by July 21, 2011, rules to establish the form and content of reports to be filed with the SEC under Section 204(b) of the Advisers Act and with the CFTC by advisers registered both under the Act and the CEA.

Authority to Restrict Mandatory Arbitration. The Act authorizes the SEC to prohibit or impose limitations on the use of agreements that require "customers or clients" of any investment adviser to arbitrate any future dispute arising under the federal securities laws, rules thereunder or the rules of a self-regulatory organization.

Studies

The Act requires the Comptroller General or the SEC to conduct a number of studies and report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services within three years (unless otherwise specified).

Study and Report on Accredited Investors. The Act requires the Comptroller General to conduct a study on the appropriate criteria for determining the financial thresholds or other criteria to qualify for accredited investor status and eligibility to invest in private funds.

Study on Custody Rule Costs. The Act requires the Comptroller General to conduct a study of the compliance costs associated with compliance with and recordkeeping related to Advisers Act custody requirements, and specifically the additional costs if subsection (b)(6) of Rule 206(4)-2 relating to operational independence were eliminated.

Study on Self-Regulatory Organization for Private Funds. The Act requires the Comptroller General to conduct a study about the feasibility of forming a self-regulatory organization to oversee private funds and report on the results by July 21, 2011.

Study and Report on Short Selling. The SEC Division of Risk, Strategy, and Financial Innovation ("Risk Fin") is required to conduct a study, taking into account current scholarship, on the state of short selling on national securities exchanges and over-the-counter markets, with a focus on the impact of recent rule changes and the incidence of (i) the failure to deliver shares sold short, or (ii) delivery of shares on the fourth day following the short sale transaction. Risk Fin must submit a report on the results of the study, including recommendations for market improvements, by July 21, 2012.

Study on Reporting of Short Sales. Risk Fin is also directed to conduct a study and report the results by July 21,2011, of the feasibility, benefits and costs of (i) requiring reporting publicly, in real time, short sale positions of publicly listed securities, or reporting such short positions in real time only to the SEC and the Financial Industry Regulatory Authority, and (ii) conducting a voluntary pilot program in which public companies agree to have all trades of their shares marked "short," "market maker short," "buy," "buy-to-cover" or "long" and reported in real time through Consolidated Tape.

The SEC's new process for pre-proposal public comment offers a unique opportunity for input into the rulemaking and studies mandated by the Act. Please contact us if you would like assistance in commenting or would like us to comment on your behalf.

Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK WASHINGTON, DC

Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

©2010 Katten Muchin Rosenman LLP. All rights reserved.

Circular 230 Disclosure: Pursuant to regulations governing practice before the Internal Revenue Service, any tax advice contained herein is not intended or written to be used and cannot be used by a taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. Katten Muchin Rosenman LLP is an Illinois limited liability partnership including professional corporations that has elected to be governed by the Illinois Uniform Partnership Act (1997). London affiliate: Katten Muchin Rosenman Cornish LLP.