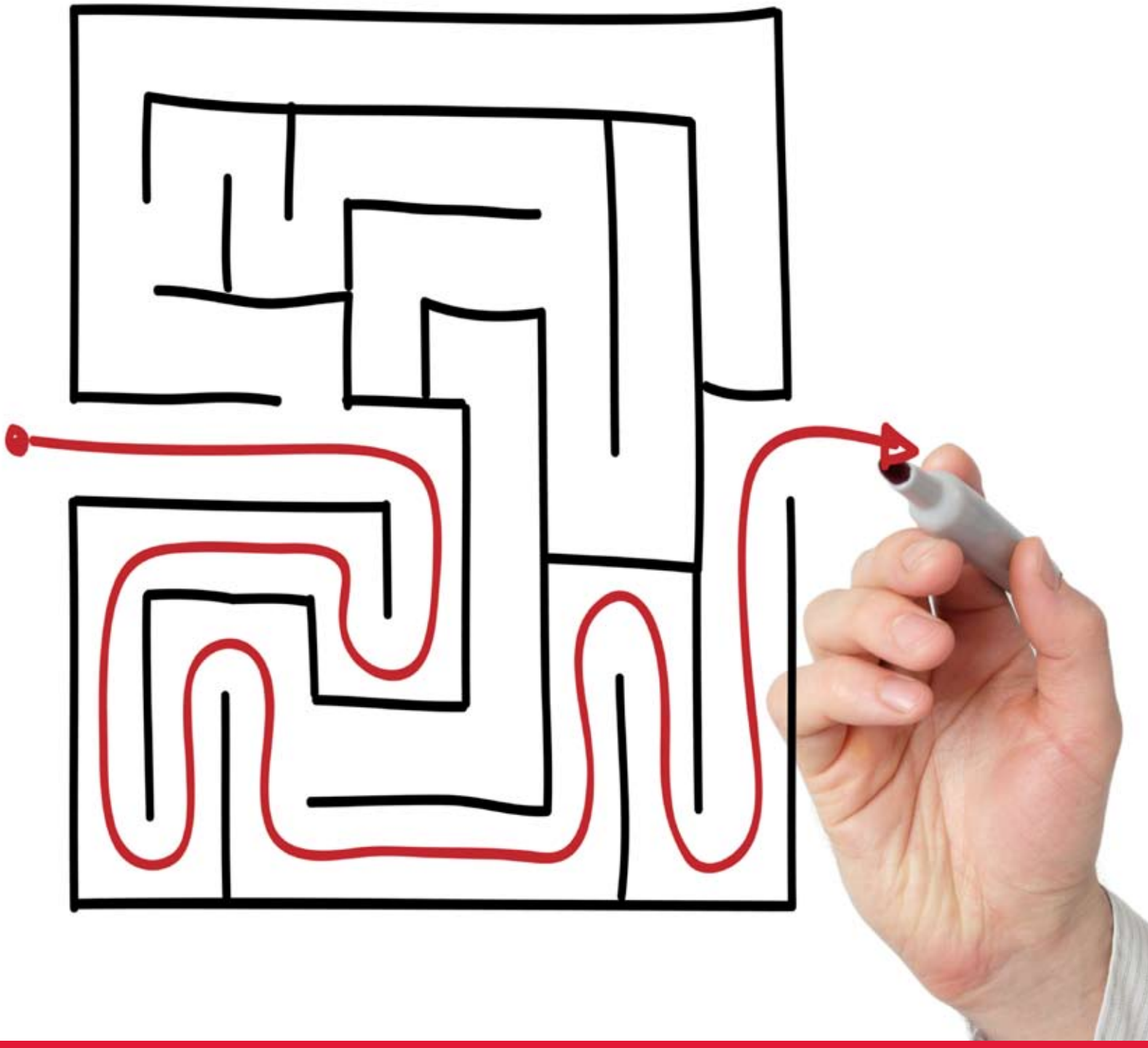

Investment Adviser Registration for Private Equity Fund Managers

MORRISON | FOERSTER

The Dodd-Frank Act will require private equity fund managers (who were previously exempt from registration) to register as investment advisers with state or federal authorities. As a result, private equity firms are bracing for the expected "culture shock" as, for the first time, they gear up for registration, a new compliance infrastructure, and public disclosure and scrutiny.

In this handbook, we summarize the principal aspects of the Dodd-Frank Act as it applies to the registration of private equity fund managers under the Investment Advisers Act of 1940. We describe who must register, the registration process, the timetable for compliance, and how registration will impact fund managers.

We note that this handbook contains only general summaries of the Dodd-Frank Act and recently proposed or enacted SEC rules.

Please contact your Morrison & Foerster Private Equity Funds attorney for more detailed guidance, and for updates on the SEC rulemaking process.

Table of Contents

Who Must Register?

Background

The Dodd-Frank Act effectively eliminates the principal Advisers Act exemption (referred to as the "fewer than 15 clients" exemption) that fund managers have long relied on to avoid state and federal registration. Prior to Dodd-Frank, an adviser with fewer than 15 clients that did not hold itself out as an investment adviser, was generally exempt from registration. As a result, very few fund managers were required to register as investment advisers, and were therefore exempt from many of the compliance obligations under the Advisers Act.

As we will discuss below, Title IV of the Dodd-Frank Act changes the "fewer than 15 clients" exemption, adds a number of new exemptions, and generally increases the dollar threshold for advisers who are required to register with the SEC. This changing regulatory landscape is expected to result in a significant number of private advisers being required to register and becoming subject to the full compliance obligations under the Advisers Act.[1]

The New Thresholds for Advisers Act Registration

The SEC has generally increased the threshold for registration with the SEC to $100 million in assets under management (AUM) rather than $25 million under the prior rules, subject to numerous exceptions. This creates the following three new categories of advisers:

- Small Advisers (<$25 million in AUM) – generally prohibited from registering with the SEC[2]
- Mid-Sized Advisers ($25 – $100 million in AUM) - generally prohibited from registering with the SEC, unless the adviser is specifically permitted or required to register with the SEC (as described in the tables below)
- Large Advisers ($100 million + in AUM) – generally required to register with the SEC, unless an exemption applies[3]

Calculating Assets Under Management

To determine which category applies to a particular fund manager, it must calculate its "regulatory assets under management." In the Implementing Release[4] (which we note is not yet final), the SEC proposed a uniform calculation of regulatory assets under management that can be used for all purposes under the Advisers Act.

In determining an advisers assets under management, the SEC instructs advisers to include the securities portfolios (including private equity funds) for which the adviser provides "continuous and regular supervisory or management services" as of the date of filing the Form ADV.

In an effort to achieve more consistency in reporting (and so advisers cannot opt into or out of state or federal regulation by including or excluding a class of assets), advisers are no longer permitted to exclude from their AUM calculations family or proprietary assets, accounts managed without receiving compensation, or assets of clients who are not U.S. persons (all of which an adviser currently may, but is not required to, exclude).

The SEC has also proposed new instructions in Form ADV to provide guidance for fund managers in determining the amount of assets the adviser has under management. Specifically, the instructions provide that:

- Advisers to private equity funds are required to include the value of any private fund over which it exercises continuous and regular supervisory or management services, regardless of the nature of the assets held by the fund;
- Value should be based on the current market value (or fair value) of the private equity fund's assets and the contractual amount of any uncalled commitments as determined within 90 days prior to the date the Form ADV is filed; and
- Market value should be determined using the same method the adviser uses to report account values to its clients.

New Exemptions Under the Dodd-Frank Act

Investment advisers who may otherwise be required to register under the Advisers Act may be able to rely upon new exemptions created by the Dodd-Frank Act.

Foreign Private Advisers

The "fewer then 15 clients" exemption has been modified to extend only to "foreign private advisers." Specifically, the new exemption is available only to advisers who:

- Have no place of business in the U.S.;
- Have less than $25 million in AUM attributable to U.S. clients and investors in "private funds" (described below) advised by the adviser, and
- Have fewer than 15 U.S. clients and investors in private funds advised by the adviser; and
- Neither holds itself out as an investment adviser in the U.S., nor acts as an adviser to an investment company or a business development company.[5]

Note that the term "private funds" under the Dodd-Frank Act includes private equity and other investment funds that would be an investment company as defined in Section 3 of the Investment Company Act but for the exemptions in Sections 3(c)(1) or 3(c)(7) thereof. Most private equity funds rely on these exemptions, and therefore would be considered "private funds" under the new rules.

Intra-State Advisers

The Dodd-Frank Act also restricts the intra-state advisers exemption. This exemption generally provides that advisers who only advise clients in one state are not required to register with the SEC. Under the Dodd-Frank Act, the intra-state advisers exemption is preserved, except that fund managers that advise private funds may not rely upon such exemption.[6]

Advisers Only to Venture Capital Funds

The Dodd-Frank Act exempts from registration fund managers that advise venture capital funds, regardless of the number or the size of the funds.[7] To rely on this exemption, a manager may only advise venture capital funds (advisers to any separate account clients may not rely on this exemption).

The SEC has proposed to define a "venture capital fund" as a private fund that:

- Invests solely in equity securities of "qualifying portfolio companies" in order to provide operating and business expansion capital;
- Acquired directly from qualifying portfolio companies at least 80% of each company's securities owned by the fund;
- Offers or provides significant managerial assistance to, or controls, the qualifying portfolio company;
- Does not borrow or otherwise incur leverage (other than on a short-term limited basis);
- Does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;
- Represents itself as a venture capital fund to investors; and
- Is not registered under the Investment Company Act and has not elected to be treated as a business development company.

The SEC has proposed to define "qualifying portfolio companies" as any company that:[8]

- At the time of any investment by the private fund, is not publicly traded and does not control, is not controlled by or under common control with another company, directly or indirectly, that is publicly traded;
- Does not borrow or issue debt obligations, directly or indirectly, in connection with the private fund's investment in such company;
- Uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and
- Is not itself an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by Rule 3a-7 of the Investment Company Act or a commodity pool.

Managers relying on this exemption will not be required to register with the SEC, but will be considered "Exempt Reporting Advisers," subject to certain limited (public) reporting requirements, including certain parts of Form ADV. Exempt Reporting Advisers are also subject to examination by the SEC.

The SEC has proposed a grandfathering provision to assist fund managers who are raising a fund during the rulemaking process and who may not otherwise qualify for the venture capital fund exemption. Under this provision, the SEC will expand the definition of "venture capital fund" to include any fund that:

- Represents to investors at the time the fund offers securities that it is a venture capital fund;
- Has sold securities to investors prior to December 31, 2010; and
- Does not sell any securities to, or accept increased commitments from, any person after July 21, 2011.

With this exception, managers of these funds may rely on the venture capital fund exemption (despite the fact that the funds they advise may not otherwise satisfy the definition of "venture capital fund" under the final rules).

Advisers Only to Private Funds

The SEC has proposed rules that would provide an exemption from registration to any investment adviser that only advises private funds if the adviser has AUM in the U.S. of less than $150 million.[9] As noted above, the term "private fund" will include most private equity funds.

Like the venture capital fund exemption, managers relying on the private funds exemption will be Exempt Reporting Advisers, and subject to SEC examination and modified reporting requirements.

Advisers Excluded from the Definition of "Investment Advisers"

An "investment adviser" is generally defined as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities,"[10] other than advisers who are:

- Banks or bank holding companies;
- Lawyers, accountants, engineers or teachers whose performance of advisory services is incidental to their profession;
- Certain broker-dealers;
- Newspaper or magazine publishers;
- Advisors whose advise relates to U.S. government securities;
- Nationally recognized statistical rating organizations; or
- Family offices.

Thus, if an investment adviser solely advises about matters other than securities, it may not be an "investment adviser" within the meaning of the Advisers Act. Where an investment adviser is not an "investment adviser" within the meaning of the Advisers Act, it will generally not be subject to the Advisers Act (and likely will not be subject to state investment advisers laws).

State vs. Federal Registration

Registration under the Advisers Act will preempt state registration.[11] If an adviser is eligible for federal registration (but federal registration is not required) it may choose between federal and state registration. It is anticipated that in this situation, many advisers will choose to register with the SEC, rather than register with the applicable state authorities, because state registration can be more onerous as it may involve registration and fees in multiple states, various testing requirements for investment adviser representatives and compliance with certain state rules regarding investment advisers and investment adviser representatives. Thus, just because an exemption from the Advisers Act is possible does not mean that an investment adviser will desire to rely upon it.

The tables below provide a short-hand look at the Dodd-Frank Act registration and exemption provisions. Please be advised that despite the summary nature of the table below, the rules in this area are complex, very fact specific, and of course subject to change. Please contact your Morrison & Foerster Private Equity Funds attorney for further guidance on determining whether your firm must register with the SEC or state authorities.

Registration Cheat Sheet

Are you an "investment adviser" within the meaning of the Advisers Act?

See discussion on page 6, under the heading "Advisers Excluded from the Definition of "Investment Advisers"

NO

You are not required to register under the Advisers Act, and are generally not required to register under state law

YES

Are you required to register with the SEC or one or more state authorities?

See Table 1 on page 8

If you are otherwise required to register with the SEC, is an exemption available?

See Table 2 on page 9

If you are otherwise required to register with one or more states, are you allowed to register with the SEC instead?

See Table 3 on page 10

Table 1: Where to Register?

In most cases, an adviser will calculate its assets under management to determine whether the adviser must be registered with the SEC or the state authorities.

Type of Adviser	Registration with SEC	Registration with State(s)
Small Advisers Less than $25 million in AUM	Prohibited, unless the state in which it maintains its principal office and place of business has not enacted an investment adviser statute.[12]	Required, unless an exception applies under state law.[13]
Mid-Sized Advisers Between $25 and $100 million in AUM	Prohibited, unless the adviser is (i) permitted to register with the SEC (see Table 3) or (ii) is generally permitted to register with the SEC because the adviser: • advises registered investment companies; or • advises "business development companies." In addition, any mid-sized adviser that: • is not registered or required to be registered as an investment adviser in the State in which it maintains its principal office and place of business; or • if registered, is not subject to examination as an investment adviser by such state regulator • is generally required to register under the Advisers Act, unless an exemption applies.	Required for mid-sized advisers that are not registered under the Advisers Act, unless an exception applies under state law. Where a mid-sized adviser is registered under the Advisers Act, state registration is not required since the Advisers Act preempts state registration.[14] However, state registration may be required if an adviser is relying upon an Advisers Act exemption.
Large Advisers $100 million or more in AUM	Required, unless an exemption applies.[15]	Not required if registered under the Advisers Act, since the Advisers Act preempts state registration.[16] However, state registration may be required if an adviser is relying upon an Advisers Act exemption.

Table 2: Exemptions from SEC Registration

Where an adviser is otherwise required to register with the SEC, the adviser may be able to rely on an exemption from SEC registration, and perhaps avoid registration altogether.[17]

Type of Adviser	Registration with SEC	Registration with State(s)
Adviser manages solely private funds and has less than $150 million in AUM	Not required, but, if relying upon the exemption, subject to modified reporting obligations of an Exempt Reporting Adviser	Required in accordance with state law, unless registered with the SEC or exempt under state law Note that Exempt Reporting Advisers relying upon the exemption are not *registered* with the SEC, and therefore may be subject to state registration
Adviser manages solely venture capital funds	Not required, but, if relying upon the exemption, subject to modified reporting obligations of an Exempt Reporting Adviser	Required in accordance with state law, unless registered with the SEC or exempt under state law Note that Exempt Reporting Advisers relying upon the exemption are not *registered* with the SEC, and therefore may be subject to state registration
"Foreign private advisers"	Not required	Required in accordance with state law, unless registered with the SEC or exempt under state law
Intrastate adviser where adviser does not advise "private funds"	Not required	Required in accordance with state law, unless registered with the SEC or exempt under state law
SBIC advisers meeting conditions under Section 203(b)(7) of the Advisers Act	Not required	Required in accordance with state law, unless registered with the SEC or exempt under state law
"Family offices"	Not required	Required in accordance with state law, unless registered with the SEC or exempt under state law
Advisers registered with the CFTC meeting conditions under Section 203(b)(6) the Advisers Act	Not required	Required in accordance with state law, unless registered with the SEC or exempt under state law
Advisers that are charitable organizations meeting conditions under Section 203(b)(4) of the Advisers Act	Not required	Required in accordance with state law, unless registered with the SEC or exempt under state law

Table 3: When is SEC Registration Permissible?

Where an adviser is otherwise required to register with one or more states, the adviser may wish to register with the SEC in order to avoid state registration. To register with the SEC, these advisers must rely on an exemption from the prohibition on SEC registration. Except as noted below, these exemptions allow advisers to choose to register with the SEC even if they do not meet the AUM thresholds described in Table 1.

Type of Adviser	Registration with SEC	Registration with State(s)
Pension consultants with respect to assets for plans having an aggregate value of at least $200 million[18]	Optional	Required in accordance with state law, unless registered with the SEC or exempt under state law
Advisers required to register with 15 or more states	Generally optional for Mid-Sized Advisers only	Required in accordance with state law, unless registered with the SEC or exempt under state law
Required to register in 30 states at the time of filing application for registration, and thereafter, would otherwise be required to register in 25 states	Optional	Required in accordance with state law, unless registered with the SEC or exempt under state law
A related adviser that controls, is controlled by, or is under common control with, an investment adviser that is registered with the SEC, and whose principal office and place of business is the same as the registered adviser	Optional	Required in accordance with state law, unless registered with the SEC or exempt under state law
An adviser that expects to be eligible for SEC registration within 120 days of filing Form ADV	Optional	Required in accordance with state law, unless registered with the SEC or exempt under state law
Internet advisers	Optional	Required in accordance with state law, unless registered with the SEC or exempt under state law

Impacts of Registration on Private Equity Fund Managers

Disclosure and Reporting Requirements

SEC-registered advisers must make periodic public filings with the SEC on Form ADV.[19] Under the proposed rules, the SEC would expand reporting requirements for private equity fund managers to include specific data about private funds and their investments. Furthermore, reporting obligations of registered advisers have already been expanded by the SEC through the new Part 2 requirements for Form ADV, which requires a detailed firm brochure in a narrative format.

Under the proposed rules, Exempt Reporting Advisers will be required to complete a subset of the proposed Part 1 of Form ADV (but not Part 2). The information required to be disclosed by Exempt Reporting Advisers includes:

- Certain identifying information about the Exempt Reporting Adviser, such as name, address, contact information, form of organization and who owns the adviser;
- Details regarding other business activities that the adviser and its affiliates are engaged in (to help the SEC identify potential conflicts);
- Disclosure of the disciplinary history for the adviser and its employees; and
- Data about the Exempt Reporting Adviser's private funds, including gross and net asset value of the private fund and a summary of the current value of the fund's investments broken down by assets and liability class and categorized in the fair value hierarchy established under U.S. GAAP (i.e., Level 1, 2 or 3 measurements).

Compliance Program

All registered advisers are required to have a compliance program[20], including:

- Written policies and procedures reasonably designed to prevent violations of the Advisers Act, securities laws and other laws;
- A proxy voting policy, an insider trading policy, and a code of ethics;
- A designated Chief Compliance Officer responsible for administering the firm's policies and procedures, and for preventing and detecting violations of securities laws;
- Periodic training on policies and procedures; and
- Annual compliance reviews

Advertising Rules

The SEC regulates advertising by investment advisers which, for fund managers, will apply to firm websites, private placement memoranda ("PPMs") and certain other written communications.

Under specific rules, the SEC generally limits or restricts advertisements that refer (i) to testimonials or past profitable investment recommendations, (ii) any representation that a graph or formula can guide the investor as to which securities to buy or sell, (iii) statements that services will be provided free of charge unless it is entirely free and without any condition or obligation; and (iv) certain advertising practices relating to the disclosure of performance information, which the SEC considers misleading.[21]

Restrictions on Performance Fees

- The Advisers Act prohibits a registered investment adviser from charging performance-based compensation (e.g., carried interest), except with respect to fee arrangements with certain types of sophisticated investors that meet the criteria of "qualified clients." Qualified clients are generally defined as:[22]
- Natural persons or companies that have at least $750,000 under management with the adviser immediately after entering into the contract;
- Natural persons or companies that the adviser reasonably believes either have a net worth of more than $1,500,000 at the time the contract is entered into or are "qualified purchasers" (as defined in the Investment Company Act); or

- Natural persons who immediately prior to entering into the contract are executive officers, directors, trustees, or general partners of the adviser or who are employees who participate in investment activities of the adviser (and have served in this capacity with the adviser or another company for at least 12 months).

Fund managers will include in its subscription agreement a representation as to each investor's net worth to ensure compliance with these rules.

Custody Arrangements

Registered advisers with "custody" of client securities or funds are subject to the custody rules under the Advisers Act.[23] Most fund managers will have custody of their client's (i.e., fund's) assets simply by having the authority under a fund's governing documents to access the client's assets. According to the custody rules, these advisers are generally required to maintain accounts with "qualified custodians," provide notices and account statements to clients regarding the account, and agree to annual surprise exams to verify client assets by an independent public accountant. Fund managers, however, are not subject to notice, account statement and surprise exam requirements if, among other conditions, the fund is (i) audited at least annually by an independent public accountant registered with, and subject to regular examination by the Public Company Accounting Oversight Board, and (ii) the fund delivers audited financial statements (prepared in accordance with GAAP) to limited partners within 120 days after the end of the fund's fiscal year.

Books and Records

Registered advisers must maintain certain business and client records, including financial information, client correspondence, advertising and performance records, and compliance documents. Advisers to private funds will also be required to maintain records and reports about each private fund it advises.

SEC Examinations

Firms registered with the SEC will also be subject to scheduled and unannounced examinations by the SEC.

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1. In addition, investment advisers who are already registered with the SEC, but who no longer meet the new AUM thresholds, will be required to deregister.
2. Advisers Act, Section 203A(a)(1)
3. Dodd-Frank Act, Section 410; Advisers Act, Rule 203A-1
4. Release No. IA-3110, Rules Implementing Amendments to the Investment Advisers Act of 1940, available at http://sec.gov/rules/proposed/2010/ia-3110.pdf
5. Dodd-Frank Act, Section 403
6. Dodd-Frank Act, Section 403
7. Dodd-Frank Act, Section 407
8. Release No. IA-3111, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets Under Management and Foreign Private Advisers, available at http://www.sec.gov/rules/proposed/2010/ia-3111.pdf
9. Dodd-Frank Act, Section 408
10. Advisers Act, Section 202(a)(11)
11. Advisers Act, Section 203A(b)
12. Advisers Act, Section 203A(a)(1) and the Implementing Release.
13. Under Section 222(d) of the Advisers Act, a state may not require an adviser to register if the adviser does not have a place of business within, and has fewer than six clients resident in, the state.
14. Advisers Act, Section 203A(b).
15. Advisers Act, Rule 203A-1; Dodd-Frank Act, Section 410.
16. Advisers Act, Section 203A(b).
17. The exemptions listed in this table are the exemptions most applicable to fund managers. Additional exemptions may be available.
18. Under the Implementing Release, the SEC has proposed to increase the threshold for pension consultants from $50 million to $200 million to ensure that, in order to register with the SEC, the consultant's activities are "significant enough to have an effect on national markets."
19. See Release No. IA-3060, Amendments to Form ADV, for the new Part 2 requirements for Form ADV, available at http://www.sec.gov/rules/final/2010/ia-3060.pdf. See the Implementing Release for the proposed changes to Part 1 of Form ADV.
20. Advisers Act, Rule 206(4)-7
21. See Clover Capital Management, Inc., SEC No-Action Letter, 1986 WL 67379, Fed. Sec. L. Rep. (CCH) ¶ 78,378 (Oct. 28, 1986).
22. Advisers Act, Rule 205-3
23. Advisers Act, Rule 206(4)-2

The Timeline

Now:

Determine whether you will be required to register with the SEC or one or more state authorities.

March 2011:

Prior to registration, advisers should give themselves ample time to prepare the Form ADV and establish the appropriate compliance programs.

June 3, 2011:

Advisers should submit their registrations by June 3, 2011 to allow for the SEC's 45-day review process.

July 21, 2011:

The provisions of the Dodd-Frank Act are effective and advisers will become subject to the Advisers Act registration, compliance, recordkeeping and disclosure requirements.

Stay Tuned

There will be more to come once the public comment period comes to an end and the final rules are released. Until then, stay tuned. We will provide updates on our dedicated regulatory reform webpage. http://www.mofo.com/resources/regulatory-reform

If you wish to receive more information on the topics covered in this handbook, please contact your regular Morrison & Foerster contact or any of the following members of our Global Private Equity Fund Group:

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