



## FINANCIAL REGULATORY REFORMS UPDATE

### Title IV — Regulation of Advisers to Hedge Funds and Others

- Elimination of Private Adviser Exemption.** The Act eliminates the “private adviser exemption” from registration for all U.S. resident advisers. The Act also excludes private funds from the exemption for intra-state advisers.
- General Exemptions.** The Act exempts from registration an adviser that solely advises one or more venture capital funds and an adviser that solely advises private funds and has U.S. assets under management of less than \$150 million, but the Act authorizes the SEC to impose recordkeeping and reporting requirements on such advisers. The Act excludes family offices, subject to certain grandfathering provisions, and exempts advisers to small business investment companies from both registration and reporting/recordkeeping requirements. The Act gives the SEC authority to impose registration and examination requirements on “mid-sized” private fund advisers.
- Foreign Private Adviser Exemption.** The Act contains a narrow exemption from registration and reporting/recordkeeping requirements for foreign private advisers. Among other requirements, the Act requires a non-U.S. adviser to count both U.S. clients and U.S. investors in private funds the adviser manages for purposes of the “fewer than 15 U.S. persons” test, and to include assets attributable to such U.S. clients and U.S. investors towards the “less than \$25 million in AUM” test.
- AUM Threshold for SEC Registration.** An adviser in the United States with more than \$100 million in AUM must, absent an exemption, register with the SEC. Subject to certain exceptions, a U.S. adviser with \$100 million or less in AUM must register with applicable State securities regulators.
- Information Sharing.** The SEC may not compel registered investment advisers to share the private fund information they disclose to the SEC with non-government third parties (*i.e.*, investors, prospective investors, counterparties and creditors); however, the SEC may share private fund information with the Oversight Council, other U.S. Government agencies or instrumentalities or a U.S. court under specified circumstances. Any “proprietary information of an investment adviser” obtained by the SEC is subject to special limitations on public disclosure.
- Effective Dates.** The Act provides for a one-year transition period from the date of enactment before the private fund adviser registration and recordkeeping/disclosure requirements go into effect. Private fund advisers may register voluntarily during the one-year transition period. However, *the net worth threshold for natural person accredited investors is effective immediately upon enactment of the Act.*

The “Private Fund Investment Advisers Registration Act of 2010” (the formal name for Title IV of the Act) significantly affects registration requirements for advisers to private pools of capital under the Investment Advisers Act of 1940 (the “Advisers Act”) by, among other things, eliminating the current “private adviser” exemption from registration for any U.S. resident adviser that has fewer than 15 clients and does not “hold itself out as an investment adviser” to the U.S. public. Title IV also creates new registration exceptions and exemptions and raises the minimum asset level to qualify for Federal registration for most U.S. resident advisers from \$25 million to \$100 million, thereby delegating supervision of a significant number of “smaller” advisers to State securities regulators.

Moreover, as discussed in more detail below, the Act includes additional important developments affecting both private fund advisers and private issuers, including revision of the accredited investor standard under the 1933 Act, new disclosure and recordkeeping requirements for both registered and unregistered investment advisers and enhanced custody provisions.

### Registration of Advisers to “Private Funds”

- “Private fund” is defined as any issuer that would be an investment company under the Investment Company Act of 1940 (the “Investment Company Act”) but for Section 3(c)(1) or 3(c)(7) (funds sold privately and either beneficially owned by fewer than 100 holders or owned exclusively by “qualified purchasers”). Because the definition of a “private fund” is limited to funds excepted by Sections 3(c)(1) and 3(c)(7), traditional futures funds and other funds that hold a limited amount of securities are not “private funds” under the Act.

### Exclusions and Exemptions from Registration

- *No Exemption for Private Equity Fund Advisers.* Unlike prior versions of the related bills, the Act does not exempt advisers to private equity funds.
- *Venture Capital Funds.* The Act exempts from registration advisers that solely advise one or more venture capital funds, requires the SEC to define “venture capital fund” and authorizes the SEC to impose recordkeeping and reporting requirements on unregistered venture capital fund advisers.
- *Family Offices.* Rather than provide an exemption from registration, the Act excludes family offices altogether from the definition of investment adviser; however, certain family offices that existed prior to January 1, 2010 will continue to be subject to the antifraud requirements in Sections 206(1), 206(2) and 206(4) of the Advisers Act. Accordingly, family offices will not be subject to the recordkeeping requirements of the Advisers Act, and non-grandfathered family offices will not be subject to its anti-fraud requirements. The SEC is directed to define the term “family office” in a manner that is consistent with current exemptive orders and in light of the range of organizational, management and employment structures that family offices employ.
- *Private Fund Advisers with U.S. Assets under Management (“AUM”) under \$150 Million.* The Act directs the SEC to exempt from registration any adviser that solely advises private funds and has U.S. AUM of less than \$150 million but authorizes the SEC to impose recordkeeping and reporting requirements on such advisers.
- *Foreign Private Advisers.* Foreign private advisers are exempt from registration and reporting/recordkeeping requirements. A “foreign private adviser” is defined 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 adviser;
  - has aggregate AUM attributable to clients in the United States and to U.S. investors in private funds it advises 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 a registered investment company or a business development company.

As a practical matter, as enacted, many currently unregistered non-U.S. private fund advisers will be required to register, because such advisers must include U.S. investors in the private funds they manage and the assets attributable to such investors towards the fewer than 15 U.S. persons and less than \$25 million AUM limits, respectively. The Act does not specify the time period during which an adviser must meet both the “fewer than 15 U.S. persons” and the “less than \$25 million AUM” tests, but if the SEC imposes current requirements, presumably those tests will apply on a rolling 12 month basis.

- *Small Business Investment Companies (“SBICs”).* Any investment adviser (other than a business development company) who solely advises SBICs licensed under the Small Business Investment Act of 1958 is exempt from registration.
- *Narrowing of Intra-State Exemption.* The Act narrows the registration exemption for investment advisers all of whose clients reside in the same State as the adviser’s principal place of business by excluding advisers to private funds from the exemption.
- *Narrowing of CTA Exemption.* The Act narrows the existing exemption for commodity trading advisors (“CTAs”) that are registered with the CFTC and whose business does not consist primarily of acting as an investment adviser by requiring that if such a CTA also advises a private fund, the CTA must register with the SEC if its predominant business becomes providing securities-related advice after the date of enactment of Title IX of the Act.

### Registration and Examination Requirements for “Mid-Sized Private Fund” Advisers

- The Act requires the SEC to take into account the size, governance and investment strategy of mid-sized private funds to determine whether they pose systemic risk and to prescribe registration and examination requirements for investment advisers to such private funds that reflect those risks.

### AUM Threshold for SEC Registration

- As a general matter, the Act amends Section 203A(a)(2) of the Advisers Act to prohibit an investment adviser in the United States with AUM of not less than \$25 million and not more than \$100 million from registering with the SEC if it is required to register and subject to examination in the State in which it maintains its principal place of business. Advisers to registered investment companies, business development companies and advisers that would be required to register in 15 or more States are excepted from this prohibition, as is an adviser that is not required to both register and be examined in its State of residence. The SEC may increase the \$100 million AUM threshold by rule. This AUM threshold does not apply to non-U.S. investment advisers if they have no presence in the United States and thus cannot register in any States.
- An investment adviser in the United States with AUM of less than \$25 million continues to be prohibited from registering with the SEC unless such an adviser advises a registered investment company or has its principal place of business in a State that does not regulate investment advisers.

### Adjustment of Accredited Investor Standard

- The Act fixes the net worth threshold of \$1 million for a natural person accredited investor for a period of four years beginning on the date the Act is enacted. This threshold applies either individually or jointly with the person’s spouse and, unlike the current threshold, *excludes the value of the individual’s primary residence. This provision is immediately effective upon enactment of the Act and affects all private offerings under Regulation D (not just offerings by private funds).* Except for this net worth threshold, the SEC may review and adjust or modify the standards by notice and

comment rulemaking during this initial four year period. The Senate Bill requires the SEC to review the natural person accredited investor standards at least once every four years thereafter and, if necessary, to adjust or modify them by notice and comment rulemaking.

### Other Significant Title IV Provisions

- *Broad Recordkeeping and Reporting Requirements for Registered Advisers to Private Funds.* Such requirements include:
  - the amount of assets under management and use of leverage, including off-balance sheet leverage;
  - counterparty credit risk fund exposure;
  - trading and investment fund 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 Oversight Council, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

The SEC may vary such reporting requirements according to the type or size of private fund being advised. The Act empowers the SEC to examine these records and to share them with the Oversight Council.

- *Custody of Client Assets.* The Act adds to the Advisers Act an explicit requirement that client assets over which a registered adviser has custody must be verified by an independent public accountant. Custody requirements are currently imposed by an anti-fraud rule that is subject to amendment by the SEC.
- *Confidentiality of Information.* The Act provides that neither the SEC nor the Oversight Council may be compelled to disclose private fund information but also states that this confidentiality requirement does not authorize the SEC or the Oversight Council to withhold information from Congress. The confidentiality requirement also does not prevent the SEC or the Oversight Council from complying with proper requests for information from any other Federal department, agency or self-regulatory organization or an order of a U.S. court in an action brought by the U.S. Government or the SEC. In addition, the Act:
  - imposes the same confidentiality requirements on other Federal agencies, departments and self-regulatory organizations that receive private fund information;
  - exempts the SEC, the Oversight Council and other such recipients of private fund information from the Freedom of Information Act; and
  - states that any “proprietary information of an investment adviser” obtained by the SEC shall be subject to the same limitations on public disclosure as facts the SEC ascertains during an examination, as provided by Section 210(b) of the Advisers Act. The Act defines such proprietary information as sensitive, nonpublic information regarding:
    - the investment or trading strategies of the investment adviser;
    - analytical or research methodologies;
    - trading data;
    - computer hardware or software containing intellectual property; and
    - any additional information the SEC determines to be proprietary.

- *New Exception from SEC Disclosure Restrictions.* Section 210(c) of the Advisers Act prohibits the SEC from requiring an investment adviser to disclose the identity, investment or affairs of any of its clients, except as may be necessary or appropriate in a particular enforcement investigation or proceeding. The Act amends Section 210(c) to provide a new exception from this prohibition, “for purposes of assessment of systemic risk.”
- *CFTC/SEC Provisions.* The Act requires the CFTC and the SEC within 12 months of enactment to promulgate jointly rules governing disclosure for advisers that are dually registered under the Advisers Act and the Commodity Exchange Act.
- The Act also provides that the new registration requirements for advisers to private funds under the Advisers Act do not absolve these advisers of any existing registration requirements to which such advisers may be subject under the Commodity Exchange Act.
- *Adjustment of Qualified Client Standard.* The Act amends Section 205(e) of the Advisers Act to require the SEC to adjust the net asset threshold for status as a qualified client for inflation within one year of the date of enactment of the Act, and every five years thereafter. Such adjustments are to be rounded to the nearest multiple of \$100,000.

### **Section 205 of the Advisers Act and State-Regulated Advisers**

- Title IX of the Act amends Section 205(a) of the Advisers Act to clarify that the Section, which imposes various restrictions on investment advisory contracts, does not apply to State-registered investment advisers.

### **Studies Authorized**

- The Act authorizes several studies, including:
  - a study by the U.S. Comptroller General on compliance costs associated with the SEC custody rule and the additional costs that would be incurred if the provision relating to operational independence of affiliated custodians was eliminated;
  - a study by the Comptroller General on private fund investor eligibility standards;
  - a study by the Comptroller General regarding the feasibility of forming a self-regulatory organization to oversee private funds; and
  - an SEC study regarding short selling on national securities exchanges and over-the-counter markets, with particular focus on the impact of recent rule changes and the incidence of failed or late deliveries of shares sold short, and the feasibility, benefits and costs of requiring real time reporting of short sale positions.

### **One-Year Transition Period**

- The majority of Title IV’s provisions take effect one year from the date of enactment, meaning that the private fund advisers subject to new requirements must be registered and/or meet recordkeeping/disclosure requirements by July 2011. Private fund advisers may register voluntarily during the one-year transition period. As noted above under “Adjustment of Accredited Investor Standard,” however, the new standard takes effect immediately upon enactment of the Act; a natural person investor will no longer be allowed to include the net value of the investor’s primary residence in calculating his or her net worth.

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