CONGRESS MANDATES REGISTRATION OF ADVISORS TO HEDGE FUNDS AND OTHER PRIVATE FUNDS

The massive financial regulation reform bill signed into law on July 21, 2010, includes the "Private Fund Investment Advisers Registration Act of 2010." It not only requires investment advisers to hedge funds to register under the Investment Advisers Act of 1940 (the "Advisers Act") but also makes several significant changes to private placement standards and record retention.

NEW DEFINITION OF "PRIVATE FUND;" ELIMINATION OF EXEMPTIONS

The new act adds a definition to the Advisers Act for "private fund" and defines it as any issuer relying on the Investment Company Act exemptions in section 3(c)(1) [the 100 owner exemption] or section 3(c)(7) [the qualified purchaser exemption]. This definition picks up not only virtually every hedge fund but also many private equity funds and venture capital funds. The new act eliminates the Advisers Act exemption for advisers to fewer than 15 clients and makes the intrastate exemption unavailable to advisers to private funds. The main effect of the definition and the changes in the exemptions will be to require advisers to such funds to register under the Advisers Act.

The new act does not require an adviser to register if it only advises "venture capital funds," but it leaves the definition of "venture capital fund" to future rulemaking by the Securities and Exchange Commission ("SEC"). A firm that acts as an adviser solely to private funds is exempted from registration under the Advisers Act if it has assets under management of less than $150 million. Even advisers to venture capital funds and advisers with less than $150 million in assets under management, although exempt from registration under the Advisers Act, may be required to maintain records and provide reports to the SEC that the SEC that it determines are "necessary or appropriate in the public interest or for the protection of investors."

The act also excludes a "family office" from the definition of investment adviser, but leaves to the SEC to define the concept by future rulemaking. The act appears to contemplate that the definition will largely mirror interpretative guidance previously given by the SEC.

ASSET LEVEL RAISED TO QUALIFY FOR SEC REGISTRATION

The amendments also raise the threshold for registration under the Advisers Act from $25 million in assets under management to $100 million. There is an exception for firms between $25 million and $100 million that would have to register with 15 or more states.

RECORDS OF PRIVATE FUNDS TO BE MAINTAINED

The SEC may require advisers for private funds to maintain records and file reports regarding private funds. The SEC may require reports that are in the public interest and for the protection of investors or for the assessment of systemic risk by the Financial Stability Oversight Council created by the reform act (the "Council").

The records and reports of any private fund to which an SEC registered adviser
provides investment advice will be deemed to be the records and reports of the investment adviser and are required to include, for each fund, a description of—
(A) the amount of assets under management and use of leverage, including off-balance-sheet leverage;
(B) counterparty credit risk exposure;
(C) trading and investment positions;
(D) valuation policies and practices of the fund;
(E) types of assets held;
(F) side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors;

(G) trading practices; and
(H) such other information as the Commission, 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.

ACCREDITED INVESTOR DEFINITION TIGHTENED

In a move that affects not just hedge funds but all private placement activity, Congress requires that the SEC adjust its definition of "accredited investor" so that the $1 million net worth calculation for individuals excludes the value of their primary residence. The new law requires the SEC to reexamine the definition every four years to consider whether it needs to be adjusted in light of the economy. The act also requires the government accountability office ("GAO") to submit a report within three years on the appropriate criteria for accredited investor status.

INVESTOR ELIGIBILITY FOR PERFORMANCE FEES TO BE ADJUSTED FOR INFLATION

The Advisers Act generally prohibits registered investment advisers from charging fees based on capital gains or appreciation, whether realized or unrealized. An SEC rule allows such performance fees to be charged to "qualified clients" as defined. Under the current version of that rule, any person with a net worth of more than $1.5 million qualifies. The new amendments require that the SEC adjust the dollar threshold for inflation within one year and then every five years thereafter. Unlike the new version of the accredited investor new worth test, the qualified client net worth test can still count the primary residence.

POSSIBLE SELF-REGULATORY ORGANIZATION FOR PRIVATE PLACEMENTS

In a very alarming development, Congress also mandated that the GAO conduct a study of the feasibility of a self-regulatory organization to oversee private funds and submit a report to Congress within one year.

***

This Alert is only a brief summary. For example, the act also includes provisions relating to commodity trading advisers, foreign private advisers, and advisers to small business investment companies, all of which are beyond the scope of this Alert. Generally, the provisions of the Private Fund Investment Advisers Registration Act of 2010 become effective July 2011, but the definition of "accredited investor" is effective immediately. Although the Private Fund Act is effective and therefore requires registration of "private fund advisers" by one year after enactment, an adviser may voluntarily register with the SEC in advance of such deadline.

If you have any questions concerning the new legislation or its application to your firm, please contact your regular Tucker Ellis & West LLP attorney or any of the following:

Glenn E. Morrical 216-696-3431
gmorrical@tuckerellis.com

Jennifer W. Berlin 216-696-5482
Jennifer.Berlin@tuckerellis.com

David S. Lu 216-696-5590
dlu@tuckerellis.com

Brent E. Culhane 216-696-5865
Brent.Culhane@tuckerellis.com

1150 Huntington Building
925 Euclid Avenue
Cleveland, OH 44115
www.tuckerellis.com