KRIEGER & PRAGER, LLP
www.kplawfirm.com

39 Broadway, Suite 920, New York, NY 10006
Tel: (212) 363-2900 - Fax: (212) 363-2999

M E M O R A N D U M

TO: Our Clients and Colleagues

FROM: Samuel M. Krieger, Esq.

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SUBJECT: **Expanded SEC Registration Requirements for Private Fund Advisers and Foreign Private Advisers**

OVERVIEW

The recently adopted United States financial reform legislation (popularly known as the Dodd-Frank Act) provides for a new layer of regulation by the United States Securities and Exchange Commission ("SEC") for hedge fund investment advisers ("Private Fund Advisers") as follows:

Advisers with $100-150 million Asset Value Management ("AUM"). An adviser with AUM of $100 million or more is presumptively required to register as an investment adviser. However, the SEC is required to provide an exemption from registration under the Investment Advisers Act (the "Act") for an adviser that acts solely as an adviser to private funds ("Private Fund Advisers") with AUM in the U.S. of less than $150 million.

Advisers with $150+ million AUM. Advisers with AUM in the U.S. of $150 million or more will be required to register with the SEC, unless they are exempt pursuant to one of the other exemptions contained in the Advisers Act.

Foreign Advisers. Many advisers based outside the United States will be required to register with the SEC. A new "foreign private adviser exemption" will apply only where the adviser: (i) has no place of business in the U.S.; (ii) has fewer than 15 U.S. clients and investors in private funds; (iii) has less than $25 million AUM attributable to U.S. clients and investors in private funds; and (iv) does not (1) hold itself out generally to the U.S. public as an investment adviser or (2) act as an adviser to a registered investment company or business development company. See "The Conondrum" herein.

Advisers not included in the above categories (or those with less than $100 million in assets under management, including many domestic advisers currently registered with the SEC), will be required to register with the various states under the applicable state registration requirements, some of which are preempted for advisers registered with the SEC. The SEC has exempted certain "family offices" and "venture capital funds" from registration.

THE FINAL SEC REGULATIONS

On June 22, 2011, the SEC adopted regulations for implementing the new rules and making changes to certain registration and reporting forms.[1] Certain of the rules implement disclosure requirements for advisers to private funds that are separate and distinct from those applicable to other registered advisers. The major new definitional rules are Rule 202(a)(30)-1 (Foreign Private Advisers) and Rule 203(m)-1 (Private Fund Advisers). As is usual, the "devil is in the details", which are summarized below in respect of Private Fund Advisers and Foreign Private Advisers.[2]

U.S. Private Fund Advisers and Sub Advisers

A Private Fund Adviser (which includes sub advisers) with its principal office and place of business in the U.S. is exempt from SEC registration if the adviser: (i) acts solely as an investment adviser to one or more "qualifying private funds"[3] and (ii) manages private fund assets of less than $150 million (including family/proprietary assets, even if no fees are charged). This would preclude an adviser who manages any managed accounts from relying on this exemption. All private fund assets managed by a U.S. adviser would be considered to be "assets under management in the U.S." even if the adviser has other offices outside of the U.S.

In order to determine the continued availability of the private fund adviser exemption, a Private Fund Adviser will be required to determine the value of its private fund assets annually based on the Regulatory AUM (as discussed below). A private fund adviser who manages private fund assets equal to or in excess of $150 million as of the end of a particular year will be required to register with the SEC within ninety (90) days of filing its annual update to Form ADV. In the case of sub-advisers, only that portion of the private fund assets for which it has responsibility will be considered in this valuation.

Foreign Private Fund Advisers

As noted in the Overview, the statutory "foreign private adviser exemption" has a $25 million threshold. Under the rules, the Private Fund Adviser Exemption will apply differently to an adviser with its principal place of business in the United States ("U.S. Fund Advisers") than it would to an adviser with a principal place of business outside the United States ("Non-U.S. Fund Advisers"). If an adviser has its principal office and place of business outside of the U.S., the adviser could avail itself of the Private Fund Adviser Exemption if: (i) the adviser has no client that is a U.S. Person (as defined in Regulation S under the Securities Act of 1933 ("Regulation S")[4] except for one or more "qualifying private funds"; and (ii) all assets managed by the adviser from a place of business in the U.S. are solely attributable to private fund assets, the total value of which is less than $150 million. [5]

Due to the relatively broad exemption available to non-U.S. advisers under the Private Fund Adviser Exemption discussed above, it is unlikely that a non-U.S. adviser will need to rely on the foreign private adviser exemption. A non-U.S. adviser will only need to count private fund assets it manages from a place of business[6] in the U.S. toward the $150 million asset threshold. A non-U.S. adviser without a place of business in the U.S. need not register with the SEC (regardless of the amount of assets in qualifying private funds), unless the adviser has U.S. clients other than qualifying private funds.

The Conundrum for Non-U.S. Advisers

If the SEC considers a Non-U.S. Fund Adviser to be subject to the registration requirement, the Non-U.S. Fund Adviser should attempt to qualify for the foreign private adviser exemption because it offers a complete exemption from the Advisers Act's requirements. Under the "foreign private adviser exemption", a Non-U.S. Fund Adviser may avoid registration only if the private funds that it advises (i) have fewer than 15 investors in the United States, and (ii) have assets under management ("AUM") attributable to U.S. investors of less than $25 million (or such higher amount as the SEC may prescribe). If, as will often be the case, the AUM attributable to U.S. investors is greater than $25 million (or such higher amount), this exemption will not be available.

As a result, many Non-U.S. Fund Advisers will be left to rely on the private fund adviser exemption. Non-U.S. Fund Advisers that are forced to rely on the private fund adviser exemption will need to get comfortable with the prospect of limited and as-yet-undefined SEC supervision and examination and would still be subject to reporting requirements.

Counting Clients and Defining Investors

The SEC addresses the look-through to investors in private funds by defining an "investor" as any person who would be included in the determination of the number of beneficial owners of the outstanding securities of a "3(c)(1) fund" ("Accredited Investors") or, with respect to a "3(c)(7) fund", ("Qualified Purchasers").[7]

The SEC has preserved the general methods of counting an adviser's clients by including certain safe harbor provisions from current Rule 203(b)(3)-1. For example, a natural person and his/her minor children or a natural person and his/her spouse who shares his/her principal residence would continue to be counted as a single client. If an adviser counts an investor in a private fund under the investor "look through" rules, the adviser does not also need to count the private fund as a client. An adviser also will be able to treat as a single investor any person who is an investor in two or more private funds advised by the investment adviser. Special rules apply to master/feeder funds. An adviser is required to include clients from which it receives no compensation.

Assets Under Management

The value of an adviser's "assets under management" will be determined in accordance with the new "regulatory assets under management" ("Regulatory AUM") calculation. The revised instructions require advisers to use the fair value of private fund assets, as opposed to other measures, such as cost basis.[8] This new definition will greatly affect real estate funds.

Advisers qualifying for the Private Fund Adviser Exemption will only be required to update their Regulatory AUM with the SEC annually.

A Non-U.S. Fund Adviser with a U.S. "place of business"[9], however, will only have to count in the AUM limited calculation the aggregate assets of its private funds that it manages from a place of business in the United States, and will be able to exclude the assets of any non-U.S. client, including private funds not managed from the United States. This means that a Non-U.S. Fund Adviser may have an unlimited number of investors (and assets under management attributable to those investors) in private funds but still qualify for this exemption so long as it does not manage assets from a place of business in the United States in excess of $150 million.

Disclosure of Information Regarding Private Funds and Private Fund Advisers

Under the final rules, both registered investment advisers and exempt reporting advisers will be required to provide detailed information to the SEC about the adviser and "private funds" they advise.

Both registered investment advisers and exempt reporting advisers will be required to provide information with respect to any private fund the adviser manages, basic organization, operations and investment information about the private funds, such as information regarding (i) the gross and net assets held by the fund; (ii) the type of investment strategy employed by the fund (to be identified from a list of available options); (iii) the number and types of investors in the fund; (iv) the minimum investment requirements of the fund; (iv) the assets and liabilities held fund by class and categorization in the fair value hierarchy of GAAP; (vi) whether clients are solicited to invest in the fund and what percentage of the adviser's other clients are invested in the fund; and (vii) the identity, location, and other information regarding certain "gatekeeper" service providers of the fund (i.e., auditors, prime brokers, custodians, administrators, and marketers).[10]

In lieu of a full Form ADV filing, exempt reporting advisers will have to complete seven items on Form ADV Part 1A with respect to the adviser, including identifying information about the adviser, form of organization, other business activities, financial industry affiliations, information about private funds it advises, control persons of the adviser and disciplinary information.[11] Registration and reporting will be done electronically through the IARD system, and will need to be updated annually. The proposed SEC rule would require investment advisers registered with the SEC that advise one or more private funds to file a Form PF with the SEC. The SEC indicated that proposed Form PF is still under consideration.

The SEC also noted that exempt reporting advisers will be subject to SEC examination; however, the scope of any examination, or how the SEC will examine Non-U.S. Fund Advisers remains unclear.[12] The SEC will address recordkeeping requirements for exempt reporting advisers in a future release.

As previously noted, a non-U.S. adviser that relies on the private fund adviser exemption would be required to comply with the limited Form ADV reporting requirements; however, a non-U.S. adviser that relies on the foreign private adviser exemption would not be subject to any reporting requirements.

COMPLIANCE HIGHLIGHTS

The substantive compliance obligations of a registered investment adviser are beyond the scope of this memorandum. (See www.sec.gov/divisions/investment/advoverview.htm)

Special mention should be made on the limitation of a registered investment adviser receiving incentive based compensation unless the client is a "Qualified Client"[12], and the disclosure requirements pursuant to Rule 206(4)-3 under the Advisers Act about solicitation arrangements with finders engaged to solicit clients for the adviser.

THE TIMELINE

Initial registration is required to be completed by March 30, 2012. The Commission recommends that applications be filed by February 14, 2012. Exempt reporting advisers must file their first reports on Form ADV electronically through IARD between January 1 and March 30, 2012. Furthermore, the various states are expected to revise their rules to regulate the lacunae arising from the new federal law and regulations.

We recommend that each adviser and sub-adviser (both U.S. and Non-U.S.) determine whether they are required to register or otherwise report to the SEC, and take appropriate steps to be in compliance prior to the deadline.

If you have any questions, or we can be of assistance in this process, please feel free to contact our office.

NOTES

1 The full text of the Amended Rules are set forth in Release No. IA-3221 and Release No. IA-3222, each dated June 22, 2011 (the "Releases") available at http://www.sec.gov/rules/final.shtml

2 The proposed Small Business Capital Access and Job Preservation Act (H.R. 1082) would exempt private equity fund advisers from registration under the Investment Advisers Act of 1940. The SEC will have the authority to define private equity fund adviser under the proposed legislation.

3 Under the Dodd-Frank Act, a private fund is an issuer that would be an investment company (as defined in the Investment Company Act (the "ICA")) but for an exemption under Section 3(c)(1) or 3(c)(7) of the ICA. In general, private funds include hedge funds, private equity funds, liquidity funds, real estate funds and securitized asset funds. The proposed rule does not provide guidance regarding whether an entity (e.g., a single member limited liability company) formed for one investor would be considered a "qualifying private fund". The final rule clarifies that an issuer that qualifies for an exclusion from the definition of "investment company" as defined in Section 3 of the ICA in addition to those provided by Sections 3(c) and 3(c)(7) may also be treated as a "private fund," provided that the investment adviser treats the issuer as a private fund for all purposes under the Advisers Act. In its release, the SEC noted that a fund with only a single investor may or may not qualify as a "private fund," depending on applicable facts and circumstances. For example, a fund that seeks to raise capital from multiple investors but has only a single, initial investor for a period of time could qualify as a private fund, as could a fund in which all but one of the investors have redeemed their interests.

4 The phrase "in the United States" is used a number of times in the context of the "foreign private adviser" exemption, and the SEC has sought to clarify its meaning for all of the purposes for which it is used by providing one definition and by conforming the relevant time for making the determination. However, the SEC's interpretation and use of the phrase "in the United States" as used in the Private Fund Adviser Exemption differs from the definition of the phrase "in the United States" as used in the Foreign Private Adviser Exemption. The proposed rule implementing the Private Fund Adviser Exemption relates "in the United States" to where the adviser manages its assets, whereas in the Foreign Private Adviser Rule, "in the United States" refers to, among other things, where the clients and investors are located. Generally, the terms "U.S. Person" and "United States" would be defined as such terms are defined in Rule 902 of Regulation S available at http://taft.law.uc.edu/CCL/33ActRls/regS.html. In addition, the SEC specifies that a person that is "in the United States" may be treated as not being in the "United States" if the person was not "in the United States" at the time of becoming a client or, in the case of an investor in a private fund, at the time the investor acquired the securities issued by the fund.

5 For these purposes, U.S. investors in a private fund will not be treated as clients; therefore, a Non-U.S. Fund Adviser could allow U.S. investors to invest in an offshore fund without being deemed to have a client in the United States that is not a private fund. A Non-U.S. Fund Adviser will have to treat as a U.S. client, however, any discretionary account set up by or for the benefit of a U.S. person by the adviser or by an affiliate of the adviser. This position is reflective of the so-called "Regulation Lite" approach previously taken by the SEC staff, where a non-U.S. adviser to non-U.S. funds was not subject to all of the regulatory requirements of the Advisers Act, even if the non-U.S. funds contained U.S. investors. But, unlike Regulation Lite, under the Private Fund Adviser Exemption, a non-U.S. adviser can manage private funds domiciled in the United States without limit as long as the adviser manages such private funds solely from a place of business outside of the United States.

6 Place of business is defined in Rule 222-1as follows:

(1) An office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and

(2) Any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

7 See the expanded discussion in our memorandum dated July 2010 entitled "Revised Regulation D Accredited Investor Standards", available at www.kplawfirm.com

[8] The instructions to the Amended Form ADV would require advisers to calculate their Regulatory AUM based on the securities portfolios for which they provide continuous and regular supervisory or management services, inclusive of proprietary assets, assets managed without receiving compensation, and assets of foreign clients, each of which an adviser may currently exclude in calculating its AUM. Regulatory AUM would also include (i) the value of any private fund over which an adviser exercises continuous and regular supervisory or management services; (ii) the amount of any uncalled capital commitments of any such private fund (a new concept intended to capture, among others, private equity fund managers); and (iii) the fair value (as opposed to the cost basis) of such private fund assets.

[9] This information need not disclose the name of the private fund but can utilize an alphabetic or numeric designation.

[10] These disclosures will be publicly available on the SEC's website and, as with other filers, will be required to be updated at least annually, within ninety days of the end of the adviser's fiscal year, and more frequently, if required by the instructions to Form ADV. The rules require an adviser to update certain items, such as identification and disciplinary information, promptly if the disclosure becomes inaccurate during the course of the year. The initial report on Form ADV for exempt reporting advisers will be required to be filed by March 30, 2012. Section 203(b)(3) will exempt a foreign private adviser from registration and any reporting or recordkeeping requirements imposed by the Advisers Act.

[11] The SEC does not intend to conduct routine examinations of exempt reporting advisers. However, the SEC will still have the authority to conduct on-site examinations of exempt reporting advisers if there are indications that such examinations are necessary. The SEC had surveyed all of the US States and from that survey was able to determine that New York and Minnesota do not have an investment adviser examination program. As such, investment advisers located in New York, Minnesota and Wyoming (which does not even have an investment adviser statute) will continue to be subject to SEC oversight and registration requirements, regardless of their assets under management.

[12] "Qualified Client" is defined, in part, as:

- A natural person who or a company that immediately after entering into the contract has at least $1,000,000 under management with the adviser;
- A natural person who or a company that the adviser (and any person acting on their behalf) reasonably believes, immediately prior to entering into the contract with the adviser, either:
    - i. Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2,000,000 (excluding the value of his or her primary residence) at the time the contract is entered into; or
    - ii. Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 at the time the contract is entered into.