PRIVATE FUND ADVISER RULES:
TO REGISTER OR NOT, THAT IS THE QUESTION

by Milton Vescovacci, Esq. and Valerie Haber*

Investment advisers to private funds will be impacted by the new rules that more clearly define and delineate the registration and reporting exemptions previously provided for in Title IV of the Dodd-Frank Act. The Private Fund Investment Advisers Registration Act of 2010 (the "Act"), adopted by Congress and signed into law by President Obama on July 21, 2010, requires that private fund advisers with more than $150 million in assets under management register with the U.S. Securities and Exchange Commission ("SEC") and comply with other reporting, recordkeeping, and examination rules. Private funds will have to wade through this complex regulatory quagmire in order to assure compliance by their investment advisers.

The long-term effect that these new rules will have on private funds and their investment advisers is unknown. What is clear is that the Dodd-Frank legislation will require many firms that were previously exempt from the registration and reporting requirements under the Investment Adviser's Act of 1940 (the "Adviser's Act") to register with the SEC, while others will have to deregister from the SEC and face state by state registration requirements and regulations. Complying with these new requirements is onerous and costly. The deadline for registering with the SEC is March 30, 2012 and all initial applications should be filed on or prior to February 14, 2012. With this deadline rapidly approaching, it is imperative that private equity firms, venture capital firms and family offices work closely with legal counsel to review the applicability of these new rules on their current operations and assess whether they are exempt or not and other alternatives to registration.

Understanding the new rules regarding available exemptions is valuable, as registration and reporting are both costly and time-consuming. Under the Act, private fund advisers do not need to register with the SEC if they fall into the following categories: (1) they advise solely venture capital funds; (2) they advise solely private funds with less than $150 million in assets under management in the U.S.; or (3) they are "foreign private advisers," having no place of business and less than 15 clients in the U.S., and less than $25 million in aggregate assets from those U.S. investors. However, the Act mandates that investment advisers exempted from registration maintain records and provide the SEC with reports as the SEC deems necessary to protect investors. These sections also require exempt investment
advisers to electronically file certain reports that will be made public on the SEC website. In this way, it is important that even exempt investment advisers understand the burdens that new reporting requirements will bring to their operations and bottom lines.

Three rules were recently passed that implement these exemptions. Rule 203(l)-1 defines "venture capital fund" as a private fund that: (i) Holds no more than 20 percent of the fund's capital commitments in non-qualifying investments (qualifying investments are generally equity securities issued to the fund by a qualifying portfolio company); (ii) does not borrow, issue debt, or guarantees or otherwise incurs leverage, other than limited short-term (less than 120 days) borrowing, in excess of 15 percent of the fund's capital contributions; (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself and markets accordingly as pursuing a venture capital strategy to its existing investors and prospective investors; and (v) is not a company required to be registered under the Investment Company Act of 1940 and has not elected to be treated as a business development company. This rule also grandfathers in pre-existing funds and exempts them as venture capital funds if such funds satisfy certain criteria, such as such pre-existing funds must have sold its securities to one or more investors prior to December 31, 2010. Other grandfathering criteria apply and it is critical for pre-existing funds to know if those rules will apply to them or not and whether such funds will otherwise need to qualify under the new venture capital fund definition or under a different exemption.

Under the new rules, venture capital fund advisers will no longer be allowed to rely on the "15 client" rule previously provided for under Section 203(b)(2) of the Adviser's Act. In other words, these investment advisers will now be able to manage more funds, as long as they meet the new definitions for venture capital funds. Additionally, foreign private funds could be exempt under this exception as well, as long as all of their clients are venture capital funds qualifying under the new rules. Funds will, however, need to take specific measures to make sure that they meet these definitions. For example, venture capital funds may want rethink their marketing strategies to more clearly represent themselves as venture capital funds to current and prospective investors. Venture capital funds may also need to develop strategies to limit the use of debt or leverage, and means by which to document this compliance. The SEC was careful to exclude funds whose strategies turn on the use of debt or leverage. Venture capital funds are, however, entitled to use up to 20 percent of their capital for "non-qualifying investment activity."

Rule 203(m)-1 was adopted to implement exemptions for investment advisers with assets under management in the U.S. of less than $150 million (the "private fund adviser" exemption). This exemption only applies to investment advisers of "private funds." Non-U.S. investment advisers can also use this exemption if they meet the criteria above, regardless of the type of clients or assets under management outside of the U.S. Private funds and their investment advisers should be aware that the SEC, in its rules, has indicated that they may consolidate the assets of affiliated entities in calculating assets under management. Therefore, even if the funds separately hold less than $150 million in assets under management, the assets may surpass the exempt threshold once consolidated, thus requiring the investment adviser to register with the SEC. The rule also sets forth detailed guidelines for calculating assets under management. This calculation must occur annually.
Foreign private advisers can also take advantage of a new exception codified in Section 202(a)(30) of the Adviser's Act. Under this provision, foreign private advisers are exempt from registration where they: (i) have no place of business in the U.S.; (ii) have no more than 14 clients and investors in the U.S. in private funds advised by the investment adviser; (iii) have aggregate assets under management attributable to U.S. clients of less than $25 million; and (iv) do not hold themselves out to the U.S. public as investment advisers. The recent rules clarify key terms included in the exception, like "investor" and "place of business," and describe how clients are to be counted. Here too it should be noted that the SEC may "look through" the nominal owners to count the number of investors. For example, investors in related feeder funds would also be counted as investors. In this way, it could be difficult to meet the 14 client threshold required for the exemption.

The SEC underscores the financial savings for investors who are able to qualify for registration exemption under these provisions. They estimate that the initial cost of registration would be $15,077, with additional compliance costs of between $10,000 and $45,000. Annual compliance and examination costs are estimated at $10,000 to $50,000. Determining whether an adviser falls within the definitions provided for in these recent rules will take both time and money. However, given the high costs of registration and compliance, the payoff is great for those who can qualify as exempt.

The exemption previously provided to investment advisers with fewer than 15 clients under the Adviser's Act meant that family offices were not required to register with the SEC. Family offices are entities that provide wealth management services to family clients. Rule 202(a)(11)(G)-1 now provides stricter criteria for family office exemptions, and defines "family offices" as those that: (1) provide investment advice only to families; (2) are wholly-owned and controlled by family members; and (3) do not hold themselves out to the public as investment advisers. Family offices must weigh the costs of SEC registration with the cost of reorganizing operations to comply with the exemption definitions.

Another important change under the Act is its modification of the net worth standard for "accredited investors" under the Securities Act of 1933. Under section 413(a), effective July 21, 2010, the individual net worth of the investor excludes the value of his or her primary residence. Furthermore, any negative equity in the investor's primary residence must be deducted in the calculation. With declining home prices, this deduction could substantially reduce the pool of available investors that qualify as accredited investors. Investment advisers should understand the new accredited investor standards in order to modify their offering and subscription documents to ensure conformity. Additionally, investment advisers should continue to obtain written representations from individual investors certifying that they meet the accredited investor standard and inquire further as to whether the value of an investor's primary residence is being excluded.

Under the Dodd-Frank Act, the Adviser's Act was amended to make a person who aids or abets a violation by another person liable to the same extent as the primary violator, expanding the scope of fines and penalties under the Adviser's Act. Consequently, investment advisers and private funds should understand the
ramifications of these new rules and consult with their counsel to ensure that they are not violating them.

For questions on this topic or others, please contact the GrayRobinson Corporate practice group.

Milton A. Vescovacci, Chair, Miami office Corporate Practice

*Valerie Haber, Summer Associate in Miami office and a J.D. candidate at the University of Miami, contributed to this article.