PRIVATE INVESTMENT FUND REGULATION IN NEW YORK

Investment Management Alert
June 22, 2012

Attorneys

Patricia Sandison

John Zak

Practices & Industries

Investment Management & Compliance

Five Thresholds for Investment Adviser Registration and Reporting

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and related Securities and Exchange Commission (SEC) regulations provide multiple new thresholds for federal investment adviser reporting, which, when coupled with the unique aspects of New York State's own regulatory scheme, have resulted in a complex pattern of registration requirements for New York-based investment advisers to private funds.

As an aid to investment advisers in New York who wish to manage a private investment fund, this article will provide a summary overview of the five thresholds for regulation of investment advisers to private funds within the state.

Some Basic Concepts

The following key terms and concepts are important to understanding federal and investment adviser registration thresholds:

Investment adviser. Under federal and New York State law, an investment adviser is 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 the advisability of investing in, purchasing, and selling securities. Thus, in addition to separate advisers to investment funds, general partners and managers of investment funds may be subject to regulation as investment advisers.

Principal office and place of business. Between the laws of various states that could apply, the federal Investment Advisers Act of 1940 generally gives primacy to the law of the state in which the investment adviser's principal office and place of business is located. The discussion in this article focuses on investment advisers whose principal office and place of business is located in New York State.

Private funds. The Advisers Act defines a private fund as an issuer that would be an investment company (that is, a company that is in the business of investing in securities) under the Investment Company Act of 1940 but for:

- The section 3(c)(1) exemption under the Investment Company Act, which generally excludes any investment company whose outstanding securities are beneficially owned by not more than 100 persons and that does not make a public offering of its securities; or
- The section 3(c)(7) exemption under the Investment Company Act, which generally excludes any investment company that is exclusively owned by "qualified investors" (i.e., very high-net-worth investors) and that does not make a public offering of its securities.

Assets under management (AUM). The amount of assets maintained under management by an investment adviser is a key determinate for a number of investment adviser reporting requirements under the Advisers Act. The SEC has adopted rules for the uniform computation of regulatory assets under management (AUM), which apply to advisers who file reports on Form ADV, including registered advisers and exempt reporting advisers. Generally, AUM for reporting purposes includes:

- The value of securities portfolios to which the adviser provides continuous and regular supervisory or management services, including the securities portfolios of non-U.S. clients that are managed from the United States;
- The value of the assets of any private fund over which the adviser exercises continuous and regular supervisory or management services;
- The amount of any uncalled capital commitments for any private fund; and
- The value of any proprietary accounts or other accounts for which the adviser provides continuous and regular supervisory or management services and receives no compensation.

Note that although the provisions for uniform computation of regulatory assets under management apply to AUM for investment advisers that report to the SEC, the SEC's implementing release concerning AUM implies that it does not apply to the determination as to whether assets should be considered under management for the purpose of determining whether an advisor is an investment adviser. For example, managing assets without compensation is not consistent with being in the business of providing advice as to the value of securities and should not by itself cause an adviser to be considered an investment adviser who is required to register.

1. Basic New York Threshold for Registration of Investment Advisers, Including Advisers to Private Funds

Generally, New York law provides that it is unlawful for an investment adviser to sell investment advisory services to more than five persons in the state (other than institutions and institutional buyers, as defined) during any 12-month period, unless the adviser is registered as an investment adviser with New York State or federally with the SEC. The term "person" includes a legal entity, such as a partnership or association, so that an investment adviser that advises a single private fund would be considered by New York to be exempt from registration.

The threshold for registration of investment advisers to private funds under New York law is reached when the adviser advises a sixth fund or any combination of individuals and funds that exceeds five. The number of investors in a private fund managed by the adviser and the AUM of the adviser are irrelevant to the need to register as an adviser with the state.

References: New York General Business Law (NYGBL) section 359-eee; 13 New York Code of Rules and Regulations (NYCRR) 11.4(c).

2. Basic U.S. Federal Threshold: Small Investment Advisers With More Than $30 Million AUM

The basic exemption from federal registration under the Advisers Act applies to any investment adviser that maintains its principal office and place of business in a state that has enacted an investment adviser statute, if an investment adviser has less than $30 million of AUM.

The Advisers Act preempts any state requirement for registration of federally registered investment advisers by prohibiting any state or political subdivision of a state from requiring the registration, licensing, or qualification of an investment adviser or supervised person of an investment adviser that is registered with the SEC. The Advisers Act does permit individual states to require notice filings, and where a federally registered investment adviser has more than five clients within the state, New York requires the adviser to file a notice copy of federal Form ADV together with the payment of an annual fee.

The Advisers Act also provides an exemption for "mid-sized" investment advisers that have between $30 million and $100 million AUM if the investment adviser is required to be registered with the securities commissioner in the state in which it maintains its principal office and place of business and, if registered, would be subject to examination as an investment adviser by the commissioner.

However, New York is one of only two states that does not provide for examinations of investment advisers registered by the state, so that the mid-sized investment adviser exemption is not available to New York-based investment advisers.

References: Advisers Act sections 203, and 203A; Advisers Act rule 203A-1; 13 NYCRR 11.5.

3. Private Fund Adviser Exemption for Investment Advisers Exclusively to Private Funds With Less Than $150 Million of AUM

The Advisers Act provides a special exemption that applies to investment advisers who exclusively provide advisory services to one or more private funds. This "private fund adviser" exemption applies to any investment adviser that:

- Has no clients in the United States other than one or more qualifying private funds (see "Some Basic Concepts" for definition); and
- Has no assets managed by the adviser that are not solely attributable to private fund assets, the total of which is less than $150 million.

Note that an adviser who relies on the private fund adviser exemption must avoid having any clients that are not private funds.

References: Advisers Act section 203(m); Advisers Act rule 203(m)-1.

4. Advisers to Private Venture Capital Funds

The Advisers Act and related rules of the SEC also provide an exemption from registration for investment advisers that solely advise private funds that are venture capital funds. A venture capital fund is a private fund that:

- Represents to its investors that it pursues a venture capital strategy;
- Holds at the time of acquisition of any asset no more than 20 percent of its aggregate capital contributions and uncalled committed assets (other than short-term holdings) in non-qualifying investments (generally, qualifying investments include equity securities issued by qualifying venture capital portfolio companies as defined under the Investment Company Act);
- Does not borrow or otherwise incur leverage in excess of 15 percent of total capital, and any such borrowing is for a term of no longer than 120 calendar days;
- Does not offer redemption or liquidity rights to its investors except in extraordinary circumstances; and
- Is not registered under the Investment Company Act and has not elected business development company status under the Investment Company Act.

For purposes of the venture capital fund exemption, an adviser may treat as a private fund any non-U.S. fund that is not offered in the United States but that would be a private fund if it were offered in a private offering in the United States.

References: Advisers Act section 203(l); Advisers Act rule 203(l)-1.

5. Exempt Reporting Advisers That Rely on the Private Fund Adviser or Venture Capital Fund Adviser Exemptions

Investment advisers who rely on either the private fund adviser exemption or the venture capital fund adviser exemption are designated as "exempt reporting advisers" and are required to file annual reports consisting of an abbreviated version of the registration form filed by registered investment advisers.

Exempt reporting advisers are not subject to the regulatory provisions that are otherwise applicable to registered investment advisers under the Advisers Act. Note, however, that the Advisers Act imposes certain operating requirements on investment advisers even where they are exempt from registration, including maintenance of procedures reasonably designed to prevent misuse of material non-public information in violation of the Securities Exchange Act; requirements governing provisions of advisory contracts relating to performance-based fees and direct or indirect assignment of the contract; restrictions on collection of performance-based fees; prohibitions on fraud; and restrictions on agency cross and principal-related transactions.

References: Advisers Act section 203(n); Advisers Act rule 204-4; Advisers Act sections 205 and 206; Advisers Act rules 205-1, 2 and 3.

The foregoing discussion should enable investment managers to private funds to form a general understanding of whether they will be required to register federally with the SEC or register with New York State. If managers decide to proceed with their proposed investment adviser activities, they should confer with appropriate legal counsel to develop a comprehensive registration and compliance program tailored to the specific operations that they will undertake.

The contents of this article are intended for general informational purposes. The statements made may be inappropriate to your particular circumstances, and they should not be construed as legal advice or an opinion on any matter. You should consult an attorney for specific advice that you may rely upon as applicable to your situation.