

How the Dodd-Frank Wall Street Reform and Consumer Protection Act Will Impact Advisers of Private Funds

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On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). While some of the more far reaching reforms were omitted from the bills initially debated in and passed by each chamber of Congress, and other provisions were dropped in the reconciliation process, the final bill will have major ramifications for financial institutions. A summary of all of the principal provisions of this sweeping act is available in our previous client alert, http://www.deweyleboeuf.com/~media/Files/clientalerts/2010/20100702_DoddFrankWallStreetReform.ashx. This alert focuses on those changes flowing from Title IV of the Act (the Private Fund Investment Advisers Registration Act of 2010) that will affect currently unregistered investment advisers of private equity funds, hedge funds and other private investment vehicles.

Of primary interest to private equity and hedge fund advisers generally are the following provisions, each of which is discussed in more detail below along with certain additional items:

1. The exemption from registration with the Securities and Exchange Commission (the "SEC") under the Investment Advisers Act of 1940, as amended (the "Advisers Act") for investment advisers having 15 or fewer clients has been eliminated, meaning that many investment advisers currently exempt will need to register by July 21, 2011;
2. Certain new exemptions from registration with the SEC under the Advisers Act have been added, specifically for:
 - (a) investment advisers that manage only "private funds" (as defined below) and have assets under management of less than \$150 million;
 - (b) foreign private advisers;
 - (c) investment advisers to "venture capital funds" (to be defined by the SEC);
 - (d) investment advisers that solely advise small business investment companies licensed under the Small Business Investment Act of 1958, as amended; and
 - (e) certain investment advisers to family offices;
3. Certain modifications have been made to existing exemptions from and qualifications for registration, specifically:
 - (a) certain investment advisers registered with the Commodity Futures Trading Commission are initially exempted; and

- (b) the threshold for registration with the SEC under the Advisers Act has been raised from \$25 million to \$100 million, meaning some investment advisers will have to withdraw their registrations and register in one or more states;
- 4. Investment advisers to private funds are required to keep extensive records with respect to such funds, which must be available for inspection by the SEC; and
- 5. The net worth portion of the "accredited investor" standard under Rule 506 of Regulation D has been revised for individuals to require net worth of \$1 million, now excluding the value of the individual's primary residence.

The New Registration Landscape

Elimination of the Private Adviser Exemption

Section 403 of the Act deletes section 203(b)(3) of the Advisers Act, which exempted investment advisers from registration with the SEC if they had fewer than 15 clients during the preceding 12-month period, did not hold themselves out to the public as investment advisers and did not act as investment advisers to a registered investment company or a business development company. This exemption has been very important to the private equity and hedge fund industry; many sponsors of such funds limited the number of funds and separate accounts that they managed so that they would qualify for the exemption. While the Act adds numerous registration exemptions (discussed in more detail below), some of which will apply to certain investment advisers who previously relied on this "private adviser" exemption, many investment advisers that previously relied on the private adviser exemption will have to register under this new regime. This provision becomes effective one year from the date of enactment of the Act, so each investment adviser that does not qualify for another exemption will have to file its Form ADV with the SEC before July 21, 2011.

Modification of "Intrastate Adviser" Exemption

The intrastate adviser exemption from registration in section 203(b)(1) of the Advisers Act has been modified by the Act. The exemption previously applied to any investment adviser whose clients were all residents of the state in which such adviser maintained its principal office and place of business, provided such adviser did not advise with respect to listed securities or securities otherwise traded on any national securities exchange. Under the Act, any such adviser is now subject to registration if even one of its clients is a private fund, as defined below, even if that private fund is located in the same state as such adviser.

"Mid-Sized" Investment Adviser Exemption

Under the Act, an adviser is generally subject to registration if it advises any "private fund," which is defined by the Act as a vehicle that would have been required to register under the Investment Company Act of 1940, as amended (the "Investment Company Act"), but for the exceptions provided by section 3(c)(1) or 3(c)(7) thereof. Section 408 of the Act, however, permits an adviser initially to qualify for an exemption from registration if it (i) solely advises private funds and (ii) has less than \$150 million in assets under management in the United States. This exemption will provide relief for investment advisers that can remain under the threshold. Under the Act, however, the SEC is instructed to determine the level of "systemic risk" posed by such advisers and funds advised by them by analyzing their size, governance and investment strategy. The SEC is required to provide for registration and examination procedures that are reflective of the level of "systemic risk" posed by such advisers and funds. As a result, some investment advisers that are initially exempt from registration under this statutory exemption may later become subject to registration and additional reporting requirements as a result of SEC rule making. In addition, investment advisers relying on this exemption will still be required to maintain such records and provide the SEC with such annual or other reports as the SEC deems necessary or appropriate in the public interest or for the protection of investors.

"Foreign Private Advisers" Exemption

Many offshore funds rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act to avoid registration as an investment company. As such, advisers to offshore funds generally will also be required to register as investment advisers, unless they qualify for an exemption. Section 403 of the Act establishes a limited exemption from registration for "foreign private advisers." A foreign private adviser is defined to include any investment adviser that (i) does not have a place of business in the United States, (ii) does not have \$25 million or more of aggregate assets under management attributable to U.S. clients and to U.S. investors in private funds managed by the adviser, (iii) has, in total, fewer than 15 clients and investors in the United States in private funds, (iv) does not hold itself out generally to the public in the United States as an investment adviser and (v) does not act as an investment adviser to any investment company or business development company registered under the Investment Company Act.

It appears likely that few foreign investment advisers will be able to rely on this exemption, because relatively few offshore investment advisers that raise capital in the United States raise less than \$25 million. An interesting question that arises under the Act is whether foreign investment advisers

that qualify for the "mid-sized" adviser exemption described above will have the option of relying on that exemption rather than the narrower "foreign private adviser" exemption. There is no clear policy reason why an investment adviser based outside of the United States would be subject to a lower dollar threshold than one based in the United States. That said, there appears to be a benefit to relying on the "foreign private adviser" exemption if applicable, as investment advisers satisfying this exemption will not have the recordkeeping and reporting requirements imposed under the "mid-sized" adviser exemption.

"Venture Capital Funds" Exemption

Section 407 of the Act provides an exemption from registration for investment advisers that solely advise "venture capital funds." No definition of this term is provided in the Act; the SEC is specifically instructed to provide one within one year of enactment. There is no established definition of a "venture capital fund," so, while certain investment advisers presumably will be confident that they will fall within any proposed definition, others likely will await the SEC rules with anxiety. If the rules put a maximum size on any venture capital fund for purposes of the exemption, then some of the more prominent venture capital firms may well find themselves required to register. As is the case for investment advisers relying on the "mid-sized" investment adviser exemption, investment advisers relying on this exemption will still be required to maintain such records and provide the SEC with such annual or other reports as the SEC deems necessary or appropriate in the public interest or for the protection of investors.

"Small Business Investment Company" Exemption

Also exempt from registration, pursuant to section 403 of the Act, is any investment adviser that (i) is not a business development company under the Investment Company Act and (ii) only advises (a) small business investment companies that are licensees under the Small Business Investment Act of 1958, (b) entities that have received notice to proceed to qualify for such licenses and (c) applicants for those licenses that are affiliated with a small business investment company.

"Family Office" Exemption

Section 409 of the Act excludes "family offices" from the definition of "investment adviser" under section 202(a)(11) of the Advisers Act. Exactly what entities will qualify as "family offices" is to be defined by the SEC in the next year in a manner that is consistent with the SEC's prior exemptive orders and certain grandfathering provisions and that recognizes the variety of structures and arrangements of family offices.

Modification of Exemption for Advisers Registered as CTAs

The Advisers Act currently exempts from registration any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading adviser if its business does not "consist primarily" of acting as an investment adviser and if it does not act as an investment adviser to any registered investment company or business development company. Section 403 of the Act expands this exemption to any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading adviser and advises a private fund, provided that if the business of such investment adviser should become "predominately" the provision of securities-related advice, then such investment adviser would be required to register with the SEC.

Increase of Threshold for Registration with the SEC

The Act increases the threshold above which investment advisers generally are permitted to be registered with the SEC from \$25 million in assets under management to \$100 million of assets under management. Accordingly, investment advisers with an aggregate of \$100 million or more of assets under management will generally be obligated to register with the SEC as investment advisers, subject to the exemptions described above. Any investment adviser whose assets under management fall short of \$100 million is prohibited from registering with the SEC unless such adviser (i) advises an investment company or a business development company under the Investment Company Act or (ii) would be required to be registered with 15 or more states. Those investment advisers that are required to withdraw their registration with the SEC will be required to register with one or more states where required by state law.

Impact of Registration at a Glance

Registration as an investment adviser will be required within the next year for many investment advisers that have avoided registration to date. Investment advisers seeking to voluntarily register prior to such date may do so subject to SEC rules. Registration under the Advisers Act requires more than the mere act of registration. In addition to specified disclosure to investors in their funds, registered investment advisers are required to designate compliance officers, maintain comprehensive compliance programs, maintain specified books and records, and undergo inspections by the SEC. In addition, the new recordkeeping and reporting requirements described below will apply. The costs of registering and complying with the Advisers Act will be significant, especially for smaller investment advisers.

Collection of Systemic Risk Data; Reports; Examinations

Investment advisers to private funds are subject to a new regulatory oversight scheme, set forth in section 404 of the Act, developed to identify those investment advisers with disproportionate market influence. Generally, the Act gives the SEC the authority to require recordkeeping and reporting by registered investment advisers and to conduct periodic and special examinations of such advisers. Under the Act, all registered investment advisers and private funds will now be required to maintain reports that include the following information for each private fund: (i) the amount of assets under management; (ii) any counterparty credit risk exposures; (iii) trading and investment positions; (iv) valuation policies and practices of the fund; (v) types of assets held; (vi) side arrangements or side letters; (vii) trading practices; and (viii) any other information that the SEC, in consultation with the Financial Stability Oversight Council established under Title I of the Act (the "Council"), determines necessary or appropriate in the public interest for the assessment of "systemic risk," which may include the establishment of different reporting requirements for different classes of investment advisers based on the type or size of the private fund(s) being advised.

The Act also requires the SEC to promulgate rules that require investment advisers to private funds to file reports that provide information that the SEC deems necessary and appropriate. As described above, investment advisers that meet the requirements of the "venture capital" exemption or the "mid-sized" exemption from registration will nevertheless be subject to such recordkeeping and reporting requirements as the SEC determines are "necessary or appropriate in the public interest for the protection of investors."

Disclosure and Information Sharing

While the reports filed with the SEC by investment advisers will not be subject to disclosure pursuant to Freedom of Information Act requests, the SEC will report to Congress on an annual basis with respect to how it uses the data collected to monitor markets and will share such information with the Council as the Council considers necessary to assess systemic risk. Moreover, the Act amends section 210(c) of the Advisers Act to permit the SEC to require an investment adviser to disclose the identity of, or information relating to, any client of such registered adviser to assess potential systemic risk.

Accredited Investor Standard

For purposes of the private placement safe harbors in Regulation D under the Securities Act of 1933, prior to passage of the Act, a natural person met the definition of "accredited investor" if he or she had an individual net worth, or joint net worth with his or her spouse, including net equity in a primary residence, that exceeded \$1 million. Section 413 of the Act amends the definition of "accredited investor" to require that the individual net worth of any natural person exceed \$1 million, excluding the value of the primary residence of such person. The SEC is also directed to review periodically the definition of "accredited investor" not less frequently than every four years, provided that the revised net worth threshold is not to be reevaluated for at least four years.

By eliminating an investor's primary residence from the net worth "accredited investor" test, the number of investors who qualify as "accredited investors" certainly will decrease. Investment advisers to private equity funds, hedge funds or other investment vehicles that are currently in their offering period and rely on section 3(c)(1) of the Investment Company Act will need to amend their subscription agreements and, if relevant language is included therein, offering documents, in order to reflect this updated definition. Unlike most of the other provisions of the Act, with respect to which compliance is not required until July 21, 2011, this change is effective immediately.

Qualified Client Standard

Section 205 of the Advisers Act generally prohibits registered advisers from entering into contracts that provide for compensation to the investment adviser on the basis of a share of capital gains upon, or capital appreciation of, the funds or any portion of the funds of the client, such as the performance fee or incentive allocation commonly charged by investment advisers to private funds. Rule 205-3 promulgated under the Advisers Act (the "Rule") provides, pursuant to section 205(e) of the Advisers Act, that only "qualified clients", as defined in the Rule, may be charged such performance-based fees. All funds that rely on section 3(c)(7) of the Investment Company Act may rely on this Rule, as all "qualified purchasers" are qualified clients. For funds relying on section 3(c)(1) of the Investment Company Act, however, the Rule is applied to fund investors on a look-through basis. Thus, for example, an investment adviser may charge a performance-based fee to a section 3(c)(1) fund only if each individual investor has a net worth in excess of \$1.5 million or at least \$750,000 invested with the investment adviser. While the Act does not immediately change these dollar amounts, the SEC is directed to review these dollar thresholds within one year from the enactment of the

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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Act and every five years thereafter, and adjust any such threshold to account for the effects of inflation.

Definition of Client

The Act specifically prohibits the SEC from defining the term "client" to include an investor in a private fund for purposes of the broad antifraud provisions in sections 206(1) and 206(2) of the Advisers Act. Accordingly, the fiduciary duties of investment advisers with respect to their clients will continue to be duties owed to the funds and other vehicles that they advise as opposed to the investors therein.

Clarification of Rulemaking Authority

In an attempt to preclude any circumvention of the newly-expanded Advisers Act, the Act explicitly provides that the SEC may ascribe different meanings to terms used in different sections of the Advisers Act, as the SEC determines necessary to effect the purposes of the Advisers Act. This authority could permit the SEC to expand the scope of the increased regulation beyond what is immediately apparent.

Conclusion

Many of the exemptions, recordkeeping and disclosure requirements and other provisions contained in Title IV of the Act will require SEC rulemaking in order for their impact to be clear. Nevertheless, it is clear that many more investment advisers now will be subject to SEC registration and oversight and heightened disclosure requirements, and that even some advisers who are not required to register will be subject to some degree of SEC oversight. These are not the only recent changes to the regulatory regime governing investment advisers (see, for example, last week's client alert on pay-to-play practices, http://www.deweyleboeuf.com/~media/Files/clientalerts/2010/20100714_PaytoPlay.ashx). We will continue to update you on further developments.

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