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Dodd-Frank Act Impact on Investment Advisers and Private Investment Funds

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was signed into law by the president.? Title IV of the Dodd-Frank Act, "Regulation of Advisers to Hedge Funds and Others," contains provisions that significantly change the registration requirements and regulation of investment advisers.? The following summary highlights some areas in Title IV of the Dodd-Frank Act that will affect our investment management clients.? Fortunately, our clients will have time to prepare for most of the changes since many aspects of Title IV of the new law do not take effect for a year. **Repeal of the Private Adviser Exemption** The Dodd-Frank Act repeals the "private adviser" registration exemption provided by Section 203(b)(3) of the Investment Advisers Act of 1940, as amended (the "Advisers Act").? Under prior law, an adviser that (1) has 15 or fewer clients in any 12-month period, (2) is not an investment adviser to a registered investment company or a business development company, and (3) does not "hold itself out" as an investment adviser, is exempt from registration with the Securities Exchange Commission (the "SEC") under the Advisers Act.? Most advisers of hedge funds and private equity funds that are not registered currently rely on this exemption.? The Dodd-Frank Act eliminates the private adviser exemption and requires advisers to "private funds" with at least $150 million in assets under management ("AUM") to register as investment advisers with the SEC under the Advisers Act unless the adviser qualifies for one of the exemptions discussed below.? The legislation broadly defines "private fund" to include any issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (the "Investment Company Act"), but for Section 3(c)(1) or 3(c)(7) of that Act.? **Exemptions from Registration** The Dodd-Frank Act provides for the following exemptions from investment adviser registration: $150 Million Exemption and Treatment of "Mid-Sized" Investment Advisers The Dodd-Frank Act requires the SEC to promulgate a rule that will exempt from registration investment advisers whose sole clients are private funds and who have total AUM in the United States of less than $150 million.? Despite this exemption, such advisers will still be subject to SEC reporting, examination, and disclosure rules discussed below. Previous law generally prohibited an investment adviser from registering with the SEC unless it had at least $25 million in AUM.? While this minimum threshold will remain in place, the Dodd-Frank Act specifically prohibits "mid-sized" investment advisers from registration with the SEC unless the investment adviser is solely an adviser to registered investment companies or business development companies.? A mid-sized investment adviser is an adviser that (1) is required to be registered as an investment adviser with the securities commissioner of the state in which it maintains its principal office and place of business and, if registered, would be subject to examination by that state commissioner, agency, or office; and (2) has AUM of $25 million to $100 million (or a higher amount as may be set by the SEC).? If a mid-sized investment adviser would be required to register with 15 or more states, then the adviser may instead elect to register with the SEC.? Advisers to Venture Capital Funds The Dodd-Frank Act provides for an exemption from registration for investment advisers that act solely as advisers to one or more venture capital funds.? Within one year after the enactment of the legislation, the SEC must issue final rules to define the term "venture capital" for purposes of this exemption.? Despite the exemption from registration, advisers to venture capital funds must maintain records and provide the SEC with reports as the SEC "determines necessary or appropriate in the public interest or for the protection of investors." Foreign Private Advisers The legislation provides a limited exemption for "foreign private advisers."? A foreign private adviser under the Dodd-Frank Act revision is an investment adviser that (1) does not have a place of business in the U.S., (2) does not have more than $25 million of aggregate AUM attributable to U.S. clients and to U.S. investors in private funds, (3) has fewer than 15 clients in the U.S., and (4) does not hold itself out generally to the public in the U.S. as an investment adviser, nor acts as an investment adviser to any registered investment company or business development company. Family Offices Under the Dodd-Frank Act "family offices" are excluded from the definition of investment adviser.? The SEC is required to promulgate a definition of

"family office."? The SEC's definition, which has no timetable for issuance, must (1) be consistent with previous exemptive policy of the SEC for family offices, (2) recognize the range of organizational, management and employment structures and arrangements employed by family offices, and (3) contain a grandfathering provision that permits family offices to provide investment advice to third parties with regard to engagements entered into prior to January 1, 2010. Advisers to SBICs The Dodd-Frank Act provides an exemption from registration for any investment adviser that solely advises "small business investment companies" ("SBICs"), licensed under the Small Business Investment Act of 1958.? The exemption also applies to advisers to entities that are currently in the process of qualification as a SBIC with the Small Business Administration.? Such exemption does not apply to an adviser that has elected to be regulated or is regulated as a "business development company" pursuant to Section 54 of the Investment Company Act. **Accredited Investor and Qualified Client Standards** Under the Dodd-Frank Act, the $1 million net worth standard for accredited investors under Regulation D of the Securities Act of 1933, as amended, excludes the value of the primary residence of the person.? Unlike most of the provisions of the Dodd-Frank Act, which are effective one year after enactment, this provision goes into effect immediately.? It will be subject to review and adjustment by notice and comment rulemaking every four years.? Similarly, Section 418 of the Dodd-Frank Act requires the SEC to amend Section 205(e) of the Advisers Act (the qualified client standard) in order to adjust for inflation.? Such adjustment by the SEC must occur within one year of enactment and every five years thereafter.? Each adjustment must be in multiples of $100,000. **Required Reports, Examinations, and Disclosures** The Dodd-Frank Act requires the SEC to establish reporting requirements for advisers to private funds within one year of the legislation's enactment. Further, the Act subjects such records to examination by the SEC. The records and reports required to be maintained by investment advisers and subject to inspection and examination by the SEC include:

> (a)?the amount of assets under management and the 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; (g)?trading practices; and (h)?such other information determined necessary and appropriate by the SEC in consultation with the Financial Stability Oversight Council (the "Council").

This provision of the Dodd-Frank Act requires that the SEC establish a schedule and conduct periodic inspections of such records maintained by investment advisers.? The SEC may conduct additional, special examinations of such records at any time as the SEC may prescribe as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk. **Confidentiality** All records and reports disclosed by investment advisers to the SEC under Title IV of the Dodd-Frank Act will be treated as confidential.? The SEC must, however, make available to the Council all reports, documents, records, and information filed with or provided to the SEC by an investment adviser as the Council may consider necessary for the purpose of assessing "systemic risk" posed by a private fund.? The Council is exempt from the ambit of the Freedom of Information Act with respect to any information made available to the Council under this provision of Title IV of the Dodd-Frank Act.? This provision does not permit the SEC or the Council to withhold information from Congress based upon a confidentiality agreement nor does it prevent the SEC from complying with a request for information from any other federal department, agency, or self-regulatory organization requesting the information for purposes within the scope of such agency's jurisdiction.? The SEC and the Council also may not refuse to comply with an order of a U.S. court in an action brought by the United States government or by the SEC. **GAO and SEC Studies** The Dodd-Frank Act requires the Government Accountability Office (the "GAO") to conduct a study of the feasibility of forming a self-regulatory organization to oversee private funds and submit a report to Congress within one year after the date of enactment.? Within three years of enactment, the GAO must conduct and submit to Congress the findings of a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds.? Within two years of enactment, the SEC's Division of Risk, Strategy and Financial Innovation must conduct and submit to Congress the findings of a study on the state of short selling on national securities exchanges and in the over-the-counter markets. **Conclusion** Title IV of the Dodd-Frank Act alters the regulatory landscape applicable to our investment adviser and investment fund clients.? This legislation requires a thorough review of nearly every aspect of compliance with the various securities laws applicable to investment advisers of private funds.? Day Pitney attorneys are readily available to provide guidance in this area and to ensure that our clients smoothly transition into compliance with the new requirements of the Dodd-Frank Act.? Please feel free to contact any of the members of our Private Equity and Investment Funds group to discuss aspects of the how the Dodd-Frank Act may apply to you.