Hodgson Russ LLP
ATTORNEYS

IMPACT OF THE DODD-FRANK ACT ON INVESTMENT ADVISERS AND HEDGE FUNDS

Investment Management Alert
July 23, 2010

Attorneys

Patricia Sandison

John Zak

Practices & Industries

Investment Management & Compliance

Six Key Regulatory Changes Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

The mammoth Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Reform Act) that President Obama signed into law on July 21, 2010, makes wide-ranging changes in the regulation of the financial industry. This article summarizes six key changes that the Reform Act will make in the regulation of investment advisers and private investment companies (commonly referred to as hedge funds).

1. The Reform Act ends the "private investment adviser exemption" from registration under the Investment Advisers Act of 1940 (Advisers Act).

Change: The Reform Act deletes the "private investment adviser exemption" from registration for investment advisers who have had fewer than 15 clients during the preceding 12 months and who do not hold themselves out to the public as investment advisers.

Significance: The Advisers Act broadly prohibits any person who is not registered or exempt from registration under that act from engaging in the business of acting as an investment adviser. Previously, the private investment adviser exemption permitted investment advisers who did not advertise their services to maintain a small number of clients without being required to register.

Investment advisers to private investment funds, whether operating as the general partner or manager of the fund or as a separate entity under an investment management agreement with the fund, are considered to have only one client for each fund they advise, so that an adviser to one or more private investment funds was normally exempt from registration as a private investment adviser because the adviser was able to claim the exemption from registration for advisers who had fewer than 15 clients during the preceding 12-month period.

As a result of the Reform Act, if an adviser advises even a single private fund or other client, and if the adviser has the requisite amount of assets under management, then the adviser must register as an investment adviser with the Securities and Exchange Commission (SEC).

2. The Reform Act creates a new "floor" for the amount of securities assets under management, which serves as the basis for determining when federal registration as an investment adviser is required.

Changes: The Reform Act provides that an investment adviser (other than an investment adviser to a registered investment company or to a business development company) may not register federally as an investment adviser if the adviser is required to register as an investment adviser in the state in which it has its principal office and place of business and has **less than $100 million of assets under management**. For purposes of determining the amount of assets that investment advisers have under management, the Reform Act requires investment advisers to private investment funds to include all of the assets of the funds that they advise.

Significance: Prior to the Reform Act, an investment adviser was permitted to register with the SEC if it had more than $25 million of client assets under management, and an adviser was required to register with the SEC if it had more than $30 million of client assets under management and had more than 14 clients. As a result of the Reform Act, investment advisers (other than advisers to registered investment companies or to business development companies) will be required to register federally if they have more than $100 million of client assets under management.

The combined effect of the removal of the private investment adviser exemption and the substantial increase in the threshold amount of assets under management before an adviser must register with the SEC will dramatically move the lines between federally registered investment advisers and state registered investment advisers. Some larger investment advisers, who advise only private investment funds with more than $100 million of assets, will become subject to investment adviser registration for the first time, and many smaller investment advisers, who manage more than $25 million and less than $100 million of client assets and were previously registered with or subject to registration with the SEC, will now be subject to registration by the individual states.

3. The Reform Act will provide a new regulatory framework for investment advisers to "private funds."

Changes: The Reform Act contains a number of provisions that, taken together, establish a new regulatory framework for investment advisers to private funds, including:

- A definition of the term "private fund" to mean an issuer that would be an investment company under the Investment Company Act but for the exclusions contained in sections 3(c)(1) (which excludes any investment company whose outstanding securities are beneficially owned by fewer than 100 persons that does not make a public offering of its securities) and 3(c)(7) (which excludes any investment company owned exclusively by "qualified purchasers" (i.e., very

high net worth investors) that does not make a public offering of its securities).

- The deletion of the private investment adviser exemption (see paragraph 1 above), coupled with the new registration threshold based on $100 million of securities assets under management including the assets of private funds managed by the adviser (see paragraph 2 above).
- The SEC is empowered to set record keeping, reporting, and examination standards for registered investment advisers with respect to private funds they advise. Within 12 months after enactment of the Reform Act, the SEC and the Commodities Futures Trading Commission (CFTC) must jointly adopt rules as to the form and content of reports to be filed with them concerning the private funds advised by registered advisers.
- The SEC must maintain the confidentiality of much of the information reported to it about private funds by the registered advisers of private funds, and the confidential information will not be subject to disclosure under the Freedom of Information Act.
- Not later than one year after enactment, the SEC must adopt rules defining the term "venture capital fund" and rules exempting venture capital funds from private fund reporting.
- Within 12 months after the enactment of the Reform Act, the SEC must adopt rules that will exempt investment advisers from registration who have up to $150 million of assets under management if they act solely as advisers to private funds.
- The SEC is directed to undertake rulemaking that will define the terms of an exclusion for "family offices" from the definition of the term "investment adviser."
- The SEC is prohibited from adopting rules that provide for the treatment of investors in private funds as "clients" of the investment advisers to the private funds they advise for the purpose of applying the standards of care required by investment advisers in dealing with their clients, if the advisers have investment management agreements with the private funds they advise that provide for the duties and responsibilities of the adviser to the fund.

Significance: The initial impact of the new regulatory framework for investment advisers to private funds will be to require many advisers to private funds to register who were not previously required to register. Although the Reform Act identifies a number of categories of information that advisers to private funds will be required to report concerning the funds they advise, the extent and nature of the required reporting will develop over time as the SEC completes the studies and reports regarding private fund advisers that it is required to undertake, and as the SEC adopts new rules based on its findings.

4. The Reform Act provides new standards for the registration or exemption of foreign investment advisers that offer investment advisory services in the United States or that advise private funds that are sold in the United States.

Change: The Reform Act provides a new exemption from registration under the Advisers Act for any foreign private adviser who meets **all** of the following qualifications:

- It has no place of business in the United States;
- It has in total fewer than 15 clients and investors in the United States in private funds advised by the investment adviser;
- It has aggregate assets under management of less than $25 million that are attributable to U.S. clients and investors in U.S. private funds advised by the investment adviser; and
- It does not hold itself out generally to the public in the United States as an investment adviser or act as an investment adviser to a registered investment company or to a business development company.

Significance: Because the Reform Act deletes the private investment adviser exemption, a new private foreign investment adviser exemption was necessary for the purpose of continuing the exempted status of foreign investment advisers who provide cross-border investment advisory services into the Unite States on a private basis. Note, however, that because the asset threshold for foreign investment advisers has been left at $25 million and because the number of clients together with the number of U.S. investors in private funds advised by the adviser must be fewer than 15 (rather than just 15 clients as provided for in the now-deleted private investment adviser exemption), many more foreign advisers who were not previously required to register will become subject to investment adviser registration.

In effect, any foreign adviser who advises a private fund with more than 14 U.S. investors or who advises a private fund that has $25 million or more of assets under management attributable to U.S. investors will be required to register under the Advisers Act.

5. The Reform Act significantly tightens the "accredited investor" standard that governs the qualification of high-net-worth investors for participation in private funds and other private offerings under the Securities Act of 1933.

Changes: The Reform Act requires the SEC to adjust the net-worth requirement for "accredited investor" status under SEC Regulation D to require that the individual net worth of any natural person, or the joint net worth of that person with his or her spouse, must be more than $1 million **excluding** the value of the primary residence of the person. The Reform Act requires the SEC to undertake a study of whether other aspects of the accredited investor standards need to be adjusted, and it requires the SEC to make adjustments to the terms of the accredited investor definition as appropriate, provided that the net-worth standard may not be readjusted until four years after enactment of the Reform Act.

Significance: Previously the $1 million net-worth standard for accredited investors did not require exclusion of the value of an investor's principal residence. Although Regulation D provides an alternative income test for accredited investors (individual income of not less than $200,000 in each of the last two years, or joint income with the individual's spouse of $300,000 in each of those years, and a reasonable expectation of the same income level in the current year), the net-worth test is generally relied upon, and the removal of the value of the investor's principal residence from the net-worth determination may be expected to substantially reduce the pool of accredited investors eligible to participate in private funds in the future.

Private funds are commonly sold exclusively to accredited investors, in part because Regulation D relieves the issuer in a private offering that is made exclusively to accredited investors from the requirement to provide each investor with the information that would have been required to be provided in a Securities Act registration statement. Since private funds typically provide for subsequent investments by existing investors, and since many of the investors in existing private funds will have been determined to be accredited on the basis of their net income at the time of their initial investment, the change in the net-worth standard for accredited investors will have immediate importance for existing private funds as well as for private funds about to be launched.

6. The Reform Act requires the SEC to determine whether a fiduciary standard should apply to brokers and dealers when they advise their customers about the value of investing in specific securities.

Changes: The Reform Act requires the SEC to study whether the standard of care that the Advisers Act applies to investment advisers when they provide personalized investment advice about securities should be applied to brokers and dealers when they advise their retail customers concerning securities investments. Within six months after enactment of the Reform Act, the SEC must submit a report on its findings and conclusions to Congress, and it may then commence a rulemaking as necessary or appropriate in the public interest "…to address the legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice to such retail customers." (§ 913(b)(10))

Significance: At the time the Reform Act was passed by Congress, there was a great deal of discussion over whether broker-dealers who give investment advice in connection with securities sales should be subject to the same fiduciary standards as investment advisers giving personalized investment advice. The proponents of the Reform Act expressed confidence that the SEC would use the powers given to it under the act to adopt rules that would require broker-dealers to be subject to the same standards as investment advisers. If rules of this kind are adopted, they may significantly affect the manner in which brokers and dealers engage in retail sales of securities.