Implications of the Dodd-Frank Act for Investment Advisers

The Private Fund Investment Advisers Registration Act of 2010 (the "Registration Act"), contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), both expands and contracts the potential universe of types of investment advisers subject to registration with the Securities and Exchange Commission (the "SEC") under the Investment Advisers Act of 1940 (the "Advisers Act"). On the one hand, it eliminates the "private adviser exemption,"[1] which is the exemption from registration used by many investment advisers (for example, advisers to hedge funds, private equity funds, real estate funds and securitization vehicles). On the other hand, the Registration Act effectively raises the threshold for SEC registration from $25 million in assets under management to $100 million in assets under management, which may preclude certain investment advisers from registering (or possibly require certain investment advisers to deregister) with the SEC.

Who Is Required to Register with the SEC under the Registration Act (and by When)?

All investment advisers with assets under management of $100 million or more are required to register with the SEC, subject to certain exemptions (including those described below). The registration provisions of the Registration Act must be complied with on or after July 21, 2011; prior to that date, the exemptions available under the Advisers Act prior to the adoption of the Registration Act may still be relied upon (including the private adviser exemption). Under the Advisers Act, an "investment adviser" generally means, subject to certain exceptions, any person who (i) for compensation, (ii) engages in the business of advising others (iii) about the value of securities, about the advisability of investing in, purchasing or selling securities, or about other investment advisers.

What Types of Investment Advisers Are Exempt from Registration with the SEC?

NON-US PRIVATE ADVISERS

A non-US private adviser is exempt from registration with the SEC, provided that it: (i) has no place of business in the United States; (ii) has fewer than 15 clients and investors in the United States in private funds[2] advised by the adviser; (iii) has less than $25 million of assets under management attributable to clients in the United States and investors in the United States in private funds advised by the adviser; and (iv) does not hold itself out generally to the public in the United States as an investment adviser and does not advise business development companies[3] or SEC-registered investment companies.

As one would expect at this point in time (i.e., soon after the enactment of the Dodd-Frank Act), the non-US private adviser exemption brings with it a good number of unresolved interpretive issues.

CERTAIN PRIVATE FUND ADVISERS

The Registration Act directs the SEC to provide an exemption from registration for investment advisers that advise solely private funds and have less than $150 million of assets under management in the United States. These advisers nonetheless are required to keep such records and provide to the SEC such reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors, a requirement that may limit the benefits of this exemption for certain investment advisers.

Because rulemaking is required, this exemption is subject to numerous uncertainties. For example, it is unclear why this exemption uses the term "assets under management in the United States," as opposed to the "clients/ investors in the United States" language included in the non-US private adviser exemption, and whether the SEC will interpret these phrases differently. Further, the Registration Act directs the SEC to take into account, with regard to mid-sized private funds, the size, governance and investment strategy of such funds, and it is unclear as to how these considerations will influence the final version of this private fund adviser exemption.

ADVISERS THAT ADVISE SOLELY VENTURE CAPITAL FUNDS[4]

The Registration Act exempts from registration with the SEC advisers that advise solely venture capital funds. These advisers nonetheless are required to keep such records and provide to the SEC such reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors, a requirement that may limit the benefits of this exemption for certain investment advisers.

The term "venture capital fund" is to be defined by the SEC within one year after the date of enactment of the Registration Act. It is not clear how the SEC will define venture capital fund as there are, of course, a myriad of possibilities for such a definition.[5] Thus, it is not clear at this point who will be able to make use of this exemption.

MID-SIZED INVESTMENT ADVISERS

The Registration Act raises the assets under management threshold for registration with the SEC from $25 million to $100 million. Specifically, "mid-sized investment advisers," (i.e., advisers with assets under management of between $25 million and $100 million that are required to be registered in their home states and, if registered, would be subject to examination) are precluded from registering with the SEC under the Registration Act.[6] Exceptions to this general rule include advisers that advise business development companies[7] or SEC-registered investment companies, and advisers that would be required, under the Registration Act, to register with 15 or more states.

Based on this mid-sized investment adviser exemption, certain mid-sized investment advisers may be required to deregister with the SEC. Of course, it remains to be seen what the impact of this mid-sized investment adviser exemption will be on mid-sized investment advisers that are already registered with the SEC. For example, will they be required to deregister with the SEC and register with a state regulator, will they have their registration status grandfathered by the SEC, or will some other approach be taken?

FAMILY OFFICES

The Registration Act excepts family offices from the definition of an investment adviser under the Advisers Act. The SEC has yet to define the term "family office," but the Registration Act requires that the exemption must: (i) be consistent with the previous exemptive policy of the SEC, as reflected in exemptive orders for family offices currently in effect; (ii) recognize the range of organizational, management and employment structures employed by family offices; and (iii) grandfather in certain investment advisers to family offices that were not registered or required

to be registered under the Advisers Act as of January 1, 2010.

ADDITIONAL EXEMPTIONS

The Registration Act also exempts from registration: (i) advisers registered with the Commodity Futures Trading Commission (the "CFTC") as commodity trading advisors that advise private funds, unless, after the date of enactment of the Registration Act, the business of that adviser becomes "predominantly"[8] the provision of securities-related advice; (ii) advisers to small-business investment companies; and (iii) intrastate advisers that do not advise private funds.

What Are the Consequences of Registering with the SEC?

The Advisers Act requires, among other things, the implementation of a comprehensive compliance program, the adoption of a code of ethics and an insider trading policy, compliance with certain custody procedures, advertising restrictions and document retention obligations, and disclosure and reporting of specified information to the SEC on Form ADV.[9] It also subjects registrants to SEC examinations.

Will There be Any Additional Disclosure and Reporting Requirements Under the Registration Act?

The Registration Act gives the SEC the power to require any registered investment adviser that advises private funds to maintain additional records and to file reports regarding those private funds with the SEC, including information about: (i) the amount of assets under management; (ii) the use of leverage (including off-balance sheet leverage); (iii) counterparty credit risk exposure; (iv) trading and investment positions; and (v) trading practices. Of course, it remains to be seen how the SEC will exercise this authority.

The Registration Act also requires that the SEC share with the Financial Stability Oversight Council (and permits disclosure to other federal departments or agencies and self-regulatory organizations) all records and reports of private funds advised by registered investment advisers (subject to certain confidentiality restrictions).

Are There Other Consequences of the Registration Act (or Any Other Titles of the Dodd-Frank Act) that are Significant for Investment Advisers?

The Dodd-Frank Act is extensive and far-reaching. Its provisions could significantly impact a broad variety of investment adviser activities. Some of the more significant items are mentioned below.

- The Registration Act precludes the SEC from defining the term "client," for purposes of Sections 206(1) and (2) of the Advisers Act, to include an investor in a private fund managed by an investment adviser if that private fund has entered into an advisory contract with such investment adviser.[10]
- As of its date of enactment, the Registration Act adjusted the methodology for calculating net worth under the Regulation D minimum net worth standard for an accredited investor who is a natural person to require that the value of the primary residence of a natural person be excluded (and directed the SEC to periodically review and adjust the accredited investor standard for natural persons).[11]
- The Registration Act also requires the SEC to adjust for inflation the dollar amounts used in the qualified client test under Section 205(e) of the Advisers Act.
- Under Section 619 of the Dodd-Frank Act (the "Volcker Rule"), subject to certain exemptions, certain banking entities[12] are banned from acquiring or retaining any equity, partnership or other ownership interest in or sponsoring a hedge fund or private equity fund. Thus, the Volcker Rule may require banks to divest

certain of their hedge fund and private equity holdings and may result in banks being less likely to acquire an ownership interest and/or sponsor hedge funds and private equity funds in the future.[13]

- In Section 721, the Dodd-Frank Act amends the definition of "commodity trading advisor" in the Commodity Exchange Act to reach advising with respect to swaps. In Section 761, the Dodd-Frank Act also makes all security-based swaps "securities" for purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934. Additionally, in Section 731, the Dodd-Frank Act creates a special fiduciary adviser role for those that would advise "special entities" (certain pension plans, endowments and government entities) with respect to swaps or securities-based swaps.
- Under Section 926 of the Dodd-Frank Act, within one year after its date of enactment, the SEC is required to issue rules for the disqualification of offerings and sales of securities under Rule 506 under the Securities Act of 1933 by a person who is subject to a final order or has been convicted of certain felonies or misdemeanors.

Does the Registration Act Require that Any Regulations be Issued or Any Studies be Conducted?

- The SEC is required to: (i) provide an exemption from registration under the Advisers Act for advisers that advise solely private funds and have less than $150 of assets under management in the United States; (ii) define the terms "venture capital fund" and "family office"; (iii) issue recordkeeping and reporting requirements for investment advisers exempt from registration under the private fund adviser exemption (in (i) above) or the venture capital fund adviser exemption; (iv) periodically review the standards applicable to accredited investor status for natural persons; and (v) periodically adjust for inflation the dollar amounts used in the qualified client test.
- The Comptroller General is required to conduct a study (and provide a report) on: (i) the appropriate criteria needed to qualify for accredited investor status; (ii) the compliance costs associated with the current custody rule; and (iii) the feasibility of forming a self-regulatory organization to oversee private funds.
- The SEC's Division of Risk, Strategy, and Financial Innovation is required to conduct a study (and provide a report containing recommendations) on short selling.

Thus, in addition to the important regulatory changes imposed by the Registration Act, equally important will be the regulations to be issued and the studies to be conducted pursuant to the Registration Act.

What Are the Relevant Effective Dates Under the Dodd-Frank Act for Certain of the Provisions Applicable to Investment Advisers?

- **July 21, 2010:** the value of a natural person's primary residence is excluded from the calculation of the $1 million net worth minimum for an accredited investor who is a natural person. In connection with the net worth calculation, the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the natural person's net worth.[14]
- **On or before July 11, 2011:** the SEC will have made an initial adjustment for inflation to the dollar amounts used in the Advisers Act qualified client test (subsequent adjustments for inflation must be made by the SEC every 5 years thereafter).

- **July 21, 2011:**[15] most provisions of the Registration Act become effective, including the elimination of the private adviser exemption, as well as the exemptions from registration under the Advisers Act for non-US private advisers, family offices, mid-sized investment advisers, certain advisers registered with the CFTC as commodity trading advisors that advise private funds, advisers that advise solely venture capital funds and advisers to small business investment companies.
- **Between July 21, 2011, and July 21, 2013:** the studies to be undertaken under the Registration Act must be completed.
- **The earlier of 12 months after the date of issuance of final rules, or July 21, 2012:** the Volcker Rule prohibitions become effective.
- **July 21, 2014:** the SEC will have adjusted the net worth standard for accredited investors applicable to natural persons to be more than $1 million (as such amount is adjusted periodically by SEC rulemaking), excluding the value of the primary residence of such natural person.
- **Currently no effective date (subject to SEC rulemaking):** (i) the definition of a family office; (ii) additional recordkeeping and reporting requirements for registered investment advisers that advise private funds; (iii) the exemption from registration under the Advisers Act for advisers that advise solely private funds and have less than $150 million of assets under management in the United States (and recordkeeping and reporting requirements for those advisers); and (iv) recordkeeping and reporting requirements for investment advisers that are exempt from SEC registration under the venture capital fund adviser exemption.

Endnotes

1 The private adviser exemption refers to Section 203(b)(3) of the Advisers Act, which exempts from registration an investment adviser that, during the preceding 12 months, had fewer than 15 clients and neither held itself out generally to the public as an investment adviser nor acted as an investment adviser to any SEC-registered investment company or business development company.

2 Under the Registration Act, "private fund" means an issuer that would be an investment company under the Investment Company Act of 1940 but for the exceptions from the definition of an "investment company" in Sections 3(c)(1) or 3(c)(7) of that act.

3 While this provision in the Dodd-Frank Act includes language indicating that to be a non-US private adviser, the adviser must not itself be a business development company, we assume that the intention was instead to exclude from the definition of non-US private adviser, advisers to business development companies.

4 One potential rationale for the exemption for advisers to venture capital funds (as opposed to advisers to private equity funds) appears to be the belief that venture capital funds do not pose the same risks to the economy as other types of funds. According to the Senate Committee on Banking, Housing, and Urban Affairs, "their activities are not interconnected with the global financial system, and they generally rely on equity funding, so that losses that may occur do not ripple throughout world markets but are borne by fund investors alone" (Committee Report 111-176, Apr. 30, 2010).

5 While the SEC could determine to formulate a definition of "venture capital fund" without reference to other analogous precedent, the SEC could also make use of similar concepts in some other existing statutes or rules as a basis for the definition. For example, ERISA includes a regulatory exemption from treatment as "ERISA plan assets" for "venture capital operating companies," which are funds that have a majority of their assets invested in operating companies with respect to which they have obtained direct contractual rights to participate substantially in the companies' management decisions (e.g., the right to designate a board member or consultation rights over major decisions). Another possible source is the definition of "venture capital company" included in the exemption from California investment adviser registration under the California Corporate Securities Law.

[6] According to a report issued by the Senate Committee on Banking, Housing, and Urban Affairs, "[t]he Committee expects that the SEC, by concentrating its examination and enforcement resources on the largest investment advisers, will improve its record in uncovering major cases of investment fraud, and that the States will provide more effective surveillance of smaller funds" (Committee Report 111-176, Apr. 30, 2010).

[7] While this provision in the Dodd-Frank Act includes language indicating that the investment adviser must not itself be a business development company, we assume that the intention was instead to exclude investment advisers to business development companies.

[8] The term "predominantly" is not defined in the Advisers Act or the Registration Act and thus its meaning in this context is yet to be determined.

[9] *See* Mayer Brown's Legal Update, "SEC Adopts Amendments to its Investment Adviser Registration Form (Part 2 of Form ADV)" for further information about the recent SEC amendments to Part 2 of Form ADV, available at http://www.mayerbrown.com/publications/article.asp?id=9383&nid=6.

[10] According to a report issued by the Senate Committee on Banking, Housing, and Urban Affairs, this provision "avoids potential conflicts between the fiduciary duty an adviser owes to a private fund and to the individual investors in the fund (if those investors are defined as clients of the adviser)" (Committee Report 111-176, Apr. 30, 2010).

[11] For further information, *see* Mayer Brown's Legal Update, "Changes to Net Worth Test for Accredited Investor Standard" available at http://www.mayerbrown.com/publications/article.asp?id=9373&nid=6.

[12] Under the Volcker Rule, banking entities are defined to include any insured depository institution, any company that controls an insured depository institution or that is treated as a bank holding company under the Bank Holding Company Act of 1956, and any subsidiary or affiliate of those entities.

[13] For further information, *see* Mayer Brown's Legal Update, "The Volcker Rule: Implications for Private Fund Activities" available at http://www.mayerbrown.com/publications/article.asp?id=9139&nid=6.

[14] SEC Compliance and Disclosure Interpretations: Securities Act Rules, available at http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm as of July 23, 2010.

[15] However, the Registration Act permits an investment adviser to apply to register with the SEC under the Advisers Act prior to July 21, 2011.

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