Regulation of Investment Advisers To Increase Under Dodd-Frank Act

On July 21, 2010, the President signed into law the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Act"). With a stated goal of bolstering confidence in the United States financial system by reducing systemic risk through increased regulation of the industry, the Act sets forth a series of sweeping initiatives that will impact the financial services industry across a diverse spectrum of operations. Among the most significant initiatives that the Act will implement is a series of reforms aimed at increasing regulation of inestment advisers to hedge funds, private equity funds and other similar investment vehicles. Titled as the *Private Fund Investment Advisers Registration Act 2010*, Title IV of the Act imposes new registration, recordkeeping, and reporting requirements on investment advisers to private investment funds. In addition, the Act also takes steps intended to address certain investor protection issues pertaining to hedge funds and similar investment funds, including increasing the monetary thresholds that trigger registration with the Securities and Exchange Commission (the "SEC") with the goal of allowing the SEC to focus its resources on larger investment advisers. Somewhat related to these measures, the Act directs the SEC to adjust the threshold for "accredited investor" status which will have some effect on investor eligibility to invest in certain of these funds.

The Act provides a one year transition period during which investment advisers impacted by its provisions may come into compliance.

I. Elimination of "fewer than 15 clients exemption"[1]

One of the most commonly used exemptions in the Investment Advisers Act of 1940 (the "IAA") to the registration requirements of the SEC is the "private adviser" exemption, which had historically provided an exemption from registration for investment advisers with fewer than fifteen clients during the preceding twelve months. The Act eliminates the "private adviser" exemption in the IAA. As a result, investment advisers who had previously relied upon the "private adviser" exemption to operate free of the registration, reporting and compliance obligations associated with being an SEC registered investment adviser will now have to either restructure their business such that they can qualify for exemption under one of the remaining or new exemptions under the IAA or comply with registration requirements of the IAA (most likely not a practical alternative given the limited nature of the remaining examptions) within the specified transition period. The remaining exemptions from registration and the timeline for transitional compliance are summarized below.[2]

II. New Exemptions to Registration Requirements for Private Fund Investment Advisers

The Act, while eliminating one of the more commonly utilized exemptions from SEC registration and reporting, also created several new exemptions that investment advisers may rely upon;

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1 *Section 203(b)(3) of the IAA.* The "private adviser" exemption had also required that the investment adviser not hold itself out to the public as an investment adviser and not serve as an investment adviser to a registered investment company or business development company.

2 The exemptions for registration are set forth in IAA Section 203(b). The text of Section 203(b) as amended by the Act is set forth in Annex A.

however, these new exemptions are generally quite limited in their applicability and in some cases, do little to alleviate the obligations associated with being SEC registered.

- Exemption for Advisers to Venture Capital Funds
    - Section 407 of the Act provides exemption from SEC registration requirements for investment advisers who act in such capacity solely with respect to one or more venture capital funds; however, the term "venture capital fund" is not defined in the Act.[3] Furthermore, the exemption appears to in practice provide investment advisers little relief from the burdens of being SEC registered, since it provides the SEC the power to require advisers who rely upon this exemption to maintain records and prepare such reports as the SEC determines necessary or appropriate.
- Exemption for Advisers to Private Funds
    - Section 408 of the Act provides SEC exemption for any investment adviser to private funds, if each such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150 million.[4] The term "private fund" is defined as an entity that would be an investment company as defined in Section 3 of the Investment Company Act (the "ICA") but for Sections 3(c)(1) or 3(c)(7) thereof.[5] Once again, however, this exemption may in reality do little to differentiate the obligations of SEC registered advisers from non-registered advisers, since the SEC is provided the power to require advisers who rely upon this exemption to maintain records and prepare such reports as the SEC determines necessary or appropriate.
- Exemption for Family Offices
    - Section 409 of the Act provides exemption from SEC registration for investment advisers operating out of family offices; however, the term "family offices" is not defined.[6] The Act specifies a variety of factors that will considered when the SEC defines such term, with the guiding principle being a definition consistent with previous exemptive policy of the SEC for such entities.
- Exemption for Foreign Private Advisers
    - Section 403 of the Act provides exemption from SEC registration for foreign private advisers, defined as being investment advisors with no place of business within the United States, fewer than fifteen clients in the United States, assets under management attributable to clients within the

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[3] *New Section 203(l) of the IAA.* The SEC was provided a deadline of one year from the enactment of the subsection in question to define such term.

[4] *New Section 203(m) of the IAA.*

[5] Section 3(c)(1) exempts from registration funds having not more than 100 security holders and section 3(c)(7) exempts from registration funds having only "qualified purchasers" as security holders and in each case, such funds must not make or propose to make a public offering of their securities.

[6] *Amended Section 202(a)(11) of the IAA.*

United States of less than $25 million and who neither hold themselves out to the public as investment advisers nor serve as investment advisers to registered investment or business development companies.[7] The low monetary threshold will likely render this exemption of little utility to most investment advisers.

- Exemption for CFTC Registered Advisers that Advise Private Funds
    - Section 403 of Act provides exemption from SEC registration for any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor and advises a private fund; however, such exemption would cease to be applicable for such entities to the extent the business of such adviser became predominately the provision of securities-related advice.[8]

III. Expanded Recordkeeping and Report Requirements for Private Fund Investment Advisers

Section 404 of the Act also significantly expands the recordkeeping and reporting obligations of registered investment advisers.[9] Such entities will now be required to maintain such records of and file such reports pertaining to private funds advised by the investment adviser as deemed necessary and appropriate by the SEC or useful for the assessment of systemic risk by the Financial Stability Oversight Council (the "Council"). For each private fund advised by the investment adviser, records would be required to maintained detailing:

- The amount of assets under management and use of leverage both on and off balance sheet;
- Counterparty credit risk exposure;
- Trading and investment positions;
- Valuation policies and practices of the fund;
- Types of assets held;
- Side arrangements whereby certain investors in the fund obtain more favorable rights than other investors;
- Trading practices; and
- Such other information as the SEC deems necessary or appropriate or useful for the assessment of systemic risk.

In addition, the SEC is empowered both to issue rules requiring each investment adviser to a private fund to file reports containing the information above and to conduct periodic inspections of the records of

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7 *Amended Section 203(b) of the IAA.*

8 *New Section 203(b)(6)(B) of the IAA.*

9 *Amended Section 204 of the IAA.*

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such funds. Investment advisers would be required to make available to the SEC copies of such records as may be prepared without undue effort, expense or delay, as the SEC may reasonably request.

IV. Increased Monetary Threshold for SEC Oversight of Investment Advisers

Section 410 of the Act increases the monetary threshold for determining whether an investor adviser falls under the oversight of the SEC or state securities regulators.[10] Prior to these changes, all investment advisers with $30 million or more of assets under management fell under the jurisdiction of the SEC, while those funds with less than such amount were under the purview of state securities regulators.[11] Investments advisers with between $25 million and $100 million of assets under management will now be registered with state securities regulators unless the investment advisers serve as an investment adviser to a registered investment company or business development company or would otherwise be required to register in fifteen or more separate states, in which case such investment advisers will again fall under the review of the SEC.

The result of increasing the monetary threshold for federal jurisdiction over investment advisers will likely be two-fold. Funds falling under state securities regulation will likely face a complicated and potentially conflicting web of state securities laws that will make compliance with the requirements of being an investment adviser increasingly difficult. When considered against the backdrop of the elimination of the "private adviser" exemption, the potential pitfalls of such a decentralized regime are likely to be multiplied given the increase in the number of investment advisers that will now be required to operate as registered entities. Meanwhile, funds falling under SEC jurisdiction can expect increased scrutiny from the federal level. With fewer funds to monitor given that the "private adviser" exemption was more commonly utilized by smaller funds likely to fall under state securities regulation, coupled with increased access to fund information and power to obtain such information, we can expect that the SEC will have greater ability to leverage its resources and thereby performing increasingly exacting reviews of private investment funds.

V. Increased Financial Eligibility Thresholds

Section 413 of the Act authorizes the SEC "to adjust" the standard for qualifying as an "accredited investor" such that the $1 million net worth threshold no longer includes the potential investor's primary residence.[12]

Furthermore, Section 418 of the Act amends the criteria for designating a "qualified client" who may be charged a carried interest or performance fee on a fund investment. The present dollar thresholds for qualified client are $750,000 in assets under management and a $1.5 million net worth.[13] The Act requires that

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10 *Amended Section 203A(a) of the IAA.*

11 *See* IAA Rule 203A-1.

12 The changes to the accredited investor standard would be specifically applicable to private placements made under the Regulation D safe harbor. However, since the Regulation D term "accredited investor" is frequently used as a reference in other many types of private offerings, including in the private offering of funds relying on the Section 3(c)(1) exemption from ICA registration, the change mandated by the Act will have implications beyond just Regulation D offerings.

13 *See* IAA Rule 205-3.

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the dollar thresholds for determining which investors are qualified clients be adjusted for inflation within one year of the passage of the Act and again every five years thereafter.

VI. Time Requirements for Compliance with the Act

Section 419 of the Act provides for an effective date of one-year from the date of the passage of the Act. During this transition period, the SEC is tasked with implementing various rules and regulations aimed at promoting the stated purposes of the relevant provisions of the Act. Investment advisers may voluntarily register with the SEC prior to the one year deadline.

VII. Conclusion

The substance of Title IV of the Act imposes significant additional operating requirements and constraints upon previously exempt investment advisers. The additional exemptions that the Act provides are unlikely to offset the "private advisers" exemption that was eliminated. When coupled with increased record maintenance and disclosure requirements for registered funds, investment advisers will be forced to either revise their operating strategy so as to qualify for an exemption from the registration requirements of the IAA or develop practices over the next year that will allow them to achieve compliance with the Act. In light of the increased SEC focus on larger investment advisers that is likely to materialize as a result of the SEC being tasked with responsibility for overseeing fewer funds, investment advisers should expect greater regulatory attention from the SEC than in the past once the transition period has expired.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Theodore Lacey at 212.701.3669 or tlacey@cahill.com

Annex A

IAA Section 203(b), as amended by the Act.

(b) The provisions of subsection (a) shall not apply to–

(1) any investment adviser other than an investment adviser who acts as an investment adviser to any private fund all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange;

(2) any investment adviser whose only clients are insurance companies;

(3) any investment adviser that is a foreign private adviser;

(4) any investment adviser that is a charitable organization, as defined in section 3(c)(10)(D) of the Investment Company Act of 1940, or is a trustee, director, officer, employee, or volunteer of such a charitable organization acting within the scope of such person's employment or duties with such organization, whose advice, analyses, or reports are provided only to one or more of the following:

(A) any such charitable organization;

(B) a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940; or

(C) a trust or other donative instrument described in section 3(c)(10)(B) of the Investment Company Act of 1940, or the trustees, administrators, settlors (or potential settlors), or beneficiaries of any such trust or other instrument;

(5) any plan described in section 414(e) of the Internal Revenue Code of 1986, any person or entity eligible to establish and maintain such a plan under the Internal Revenue Code of 1986, or any trustee, director, officer, or employee of or volunteer for any such plan or person, if such person or entity, acting in such capacity, provides investment advice exclusively to, or with respect to, any plan, person, or entity or any company, account, or fund that is excluded from the definition of an investment company under section 3(c)(14) of the Investment Company Act of 1940;

(6) (A) any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor whose business does not consist primarily of acting as an investment adviser, as defined in section 202(a)(11) of this title, and that does not act as an investment adviser to—

(i) an investment company registered under title I of this Act; or

(ii) a company which has elected to be a business development company pursuant to section 54 of title I of this Act and has not withdrawn its election; or

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(B) any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor and advises a private fund, provided that, if after the date of enactment of the Private Fund Investment Advisers Registration Act of 2010, the business of the advisor should become predominately the provision of securities-related advice, then such adviser shall register with the Commission.

(7) any investment adviser, other than any entity that has elected to be regulated or is regulated as a business development company pursuant to section 54 of the Investment Company Act of 1940 (15 U.S.C. 80a-54), who solely advises--

(A) small business investment companies that are licensees under the Small Business Investment Act of 1958;

(B) entities that have received from the Small Business Administration notice to proceed to qualify for a license as a small business investment company under the Small Business Investment Act of 1958, which notice or license has not been revoked; or

(C) Applicants that are affiliated with 1 or more licensed small business investment companies described in subparagraph (A) and that have applied for another license under the Small Business Investment Act of 1958, which application remains pending.

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