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Many Private Fund Managers Must Register as Investment Advisers under Financial Reform Legislation

- Venture capital fund managers exempt
- Most fund managers (whether or not registered) will be subject to record-keeping and reporting obligations

The Dodd-Frank Wall Street Reform and Consumer Protection Act, which becomes law July 21, brings significant changes for managers of hedge funds, private equity funds, and – to a lesser but not insignificant extent—venture capital funds as it mandates investment adviser registration and reporting for many private fund managers.



Matthew C. Dallett, Partner

Most amendments to the Investment Advisers Act of 1940 (“IAA”) will take effect in July 2011. Most provisions will need new SEC regulations for clarification or implementation. The SEC has a huge amount on its plate, so it is unlikely that they’ll issue real direction for some months. However, this means that there is still an opportunity for fund managers to influence the eventual regulatory burden during the rule-making process.

The following is a summary of the changes Dodd-Frank makes to registration and compliance requirements for fund managers as well as the consequences of registration.

Private Investment Adviser exemption eliminated

The current IAA exemption from SEC registration for investment advisers (including “private fund” managers¹) that have 14 or fewer clients will be eliminated.

As a result, all fund managers will be required to register as investment advisers unless (a) they provide services only to

¹ A “private fund” is an entity that would be an investment company but for either §3(c)(1) (requiring that there be no more than 100 beneficial owners) or §3(c)(7) (requiring that investors be qualified purchasers) of the Investment Company Act of 1940.

funds meeting the to-be-defined venture capital exemption, or (b) they have less than \$150m of assets under management (“AUM”), as described below.

Formerly exempt managers will have a registration deadline in July 2011, although earlier registrations will be permissible.

The exemption is preserved for foreign advisers with 14 or fewer U.S. clients (including investors in private funds) and less than \$25m AUM “in” the U.S.

A commodity trading adviser registered with the CFTC is exempt from SEC registration, even if it manages private funds, unless its business is “predominantly the provision of securities-related advice.”

New exemption from registration for Private Fund Advisers with less than \$150m AUM in the US

An adviser whose sole clients are “private funds” will be exempt from SEC registration if its total AUM “in the United States” is less than \$150m.²

² The SEC generally considers advisory business conducted by affiliated companies under common management to be integrated for purposes of IAA coverage, so one probably cannot avoid registration and compliance for fund management by segregating it from other advisory business.



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- Note that (as now) a fund manager may have to register with one or more states, absent an applicable exemption, even though it is exempt from SEC registration.³

Advisers relying on this new exemption must comply with new recordkeeping and reporting requirements to be adopted by the SEC. They will apparently also be subject to SEC examination.

- An open question is whether these new SEC recordkeeping and reporting requirements will apply to an adviser that is covered by this exemption but required to register with its home state.

Fund managers will need to expand their supervisory / compliance procedures to cover the new recordkeeping and reporting requirements.⁴

Venture Capital exemption from registration, but not recordkeeping requirements

An adviser (irrespective of AUM) whose sole clients are “venture capital funds” is exempt from SEC registration.⁵

The SEC must define “venture capital fund” for purposes of this exemption.

- The Act states no criteria for this. The SEC may look to the portion of a fund’s assets that are in venture capital-type investments, the investors’ lockup period, or other

factors. Managers of some nominal “private equity” funds may be able to fit within the ultimate exemption.

Advisers relying on this exemption will need to comply with recordkeeping and reporting requirements promulgated by the SEC. Accordingly, the exemption may not provide much benefit compared to registered status.

VC managers will need to expand their supervisory / compliance procedures to cover the new recordkeeping and reporting requirements.

Recordkeeping and examination requirements for SEC-registered advisers

The Act gives the SEC broad power to require SEC-registered advisers to maintain and produce extensive records on the private funds they manage.

- The SEC may distinguish between different types or sizes of fund, depending on its perception of the risks that each present.
- Registered advisers are subject to periodic SEC examinations anyway; the Act underscores that these may cover private fund operations.

“Accredited Investor” net worth standard revised

Effective immediately, the net worth standard for determining “accredited investor” status of an individual must exclude the value of his or her primary residence.

\$1 million, which is the current individual net worth standard for accredited investor status would be set as a mandatory minimum and would be subject to adjustment (for inflation and investor protection considerations generally) by the SEC beginning in 2015.

These changes will reduce the pool of eligible investors for private funds managed by unregistered advisers who need not comply with the qualified client criteria discussed below. Of course, the number of such unregistered advisers will shrink as the Act takes effect.

“Qualified Client” criteria to be adjusted for inflation

SEC-registered advisers may not charge a fee based on account performance (including a carried interest) to any client or investor not meeting certain financial criteria. Currently, such “qualified clients” must have either \$750,000 under management with the adviser or a net worth (with spouse) of at least \$1.5m, or be a “qualified investor” (having investable assets of at least \$5m).

The Act requires the SEC to adjust the net worth test for inflation beginning in July 2011 and every five years thereafter. This will theoretically reduce the pool of eligible investors for private funds.

Consequences of SEC registration

In general, an investment adviser registered with the SEC must:

1. Adopt, maintain and test detailed written supervisory policies and procedures designed to ensure compliance with applicable law.⁶
2. Adopt a code of ethics designed to ensure compliance with fiduciary standards.
3. Disclose and obtain client consent to transactions involving conflicts of interest.
4. Adhere to certain requirements regarding client agreements.
5. Not charge a fee based on account performance (including a carried interest) to any client or investor not meeting the “qualified client” criteria discussed above.
6. Comply with detailed recordkeeping and requirements.
7. Become subject to periodic SEC examinations.
8. Comply with surprise annual audit and disclosure requirements regarding advisory assets over which the advisor has control going beyond the limited power to execute transactions.

³ Federal preemption generally applies to advisers registered with SEC, not those who are exempt from SEC registration. The typical state law exemption relied on by private fund managers located in Massachusetts is for advisers whose only clients in the state are “institutional investors,” which is defined to include any entity whose only investors are accredited investors, each of whom has invested at least \$50,000. A New York-based adviser with only institutional clients (and up to five others) is not even defined as an “investment adviser.”

⁴ Note that fund managers and other investment advisers that are exempt from registration now are still subject to the anti-fraud provisions of the Investment Advisers Act and must have adequate supervisory procedures to ensure compliance with applicable law.

⁵ See note 2.

⁶ As noted above, this effectively applies to unregistered advisers anyway, since a failure to supervise that results in a breach of the law exposes any adviser to sanctions under the anti-fraud provisions of the IAA.

This applies to any adviser that is, or that has an affiliate that is, a general partner, LLC manager, or trustee, among others.

9. Comply with restrictions on advertising and marketing materials. This includes restrictions on how prior performance is presented in offering materials.
10. Comply with client privacy requirements.
11. Make ongoing public disclosures about matters such as AUM, number and nature of clients, industry affiliations, conflicts of interest and fees.
12. Comply with “pay-to-play” regulations limiting political contributions that can be made if the adviser manages state or local government assets, including pension funds, and limiting the persons who may solicit such business.

13. Comply with disclosure and other requirements when paying for solicitation of clients or investors.
14. Adopt a proxy voting policy.
15. Possible state registration requirements for “investment adviser representatives,” depending on the level of “retail” clients.
16. Adopt procedures to ensure business continuity in the event of a disaster.

Actions to take now

Because the shape and burden of the Dodd-Frank Act’s requirements depends so much on SEC rule-making, fund managers and other advisers should seek to influence the rule-making process. This includes working through industry groups and commenting on the proposed rules when they are published.

Managers that are likely to face registration should begin planning for the compliance changes involved. In particular, this requires a careful assessment of risks applicable to the business and crafting of policies and procedures to address them.

Our lawyers can help you formulate comments to the SEC and plan for the new compliance regime. If you would like further information, please contact the Edwards Angell Palmer & Dodge LLP lawyer responsible for your matters or one of the lawyers listed below.

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