Client Alert.

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Changes in Registration and Reporting Requirements for Private Funds under the Investment Advisers Act of 1940 in the Dodd-Frank Act

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On July 15, 2010, the United States Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). President Obama is expected to sign the Dodd-Frank Act into law during the week of July 18, 2010. Title IV of the Dodd-Frank Act, subtitled the Private Fund Investment Advisers Registration Act of 2010, includes a number of amendments to the Investment Advisers Act of 1940 (the "Advisers Act") relating to registration and reporting requirements for investment advisers to private funds.

In summary, the Dodd-Frank Act requires investment advisers to private equity and hedge funds with more than $150 million of assets under management ("AUM") to register with the Securities and Exchange Commission (the "SEC" or the "Commission").[1] Investment advisers to venture capital funds are exempt from registration, but will be subject to heightened reporting requirements. The discussion below details specific changes to the Advisers Act, which are expected to go into effect one year after the enactment of the Dodd-Frank Act.

CHANGES TO REGISTRATION EXEMPTIONS FOR INVESTMENT ADVISERS TO PRIVATE FUNDS

The Dodd-Frank Act first removes two existing exemptions from registration under the Advisers Act that most investment advisers to private funds currently rely upon in order to avoid registration. The Dodd-Frank Act repeals in its entirety the so-called "Private Adviser Exemption" previously found in Section 203(b)(3) of the Advisers Act. This provision currently exempts from registration any investment adviser that has had fewer than 15 clients during the preceding twelve month period and does not hold itself out to the public as an investment adviser.[2]

Additionally, the Dodd-Frank Act removes "private fund" investment advisers from the general exemption for intrastate investment advisers found under Section 203(b)(1). The Dodd-Frank Act defines the term "private fund" as an issuer that would be an investment company as defined by the Investment Company Act of 1940 (the "40 Act") but for the

[1] Although beyond the scope of this memorandum, generally speaking, investment advisers that are registered under the Advisers Act are subject to several specific restrictions on their operations and compliance and record-keeping obligations, including, *inter alia*: (1) being required to file with the Commission a Form ADV, which is required to be updated at least annually and part of which is required to be delivered to prospective investors; (2) being required to designate a chief compliance officer and maintain a set of compliance policies governing the adviser's operations, including a written code of ethics and employee trading policies designed to prevent securities laws violations; (3) being subject to requirements on its client advisory contracts, including prohibitions on performance-based client fees for certain types of clients; and (4) restrictions on compensation of internal and third party solicitors of prospective investors.

[2] Many advisers to hedge and private equity funds, and other types of "blind pool" investment vehicles, currently are able to rely on this exemption because each fund is treated as one client for the purposes of this exemption, regardless of the number of investors in the fund. As a result, fund managers that advise fewer than 15 funds could rely upon this exemption from registration under the Advisers Act.

exemptions provided by Sections 3(c)(1) or 3(c)(7) of that act (each, a "Private Fund"). Private equity, venture capital, real estate opportunity and hedge funds generally rely upon these exemptions in order to avoid registration under the 40 Act.

The Dodd-Frank Act adds new exemptions for various types of investment advisers. These new exemptions include:

- "foreign private advisers," which the Dodd-Frank Act defines as any investment adviser that (i) has no place of business in the United States, (ii) has fewer than 15 clients domiciled in the United States, (iii) manages less than $25 million of assets attributable to United States investors, and (iv) neither holds itself out to the public in the United States as an investment adviser nor acts as an investment adviser to an investment company registered under the 40 Act nor has elected to be a "business development company" (as defined under the 40 Act);
- any "family office," which the Dodd-Frank Act defines by reference to rules to be created by the Commission;
- any investment adviser that solely advises small business investment companies ("SBICs") that are either licensed or are currently applying for licenses under the Small Business Investment Act of 1958; and
- any investment adviser to a "venture capital fund," which term the Dodd-Frank Act directs the Commission to define by final rule within one year of the enactment of the Dodd-Frank Act.

In addition to the express exemptions described above, the Dodd-Frank Act also directs the Commission to provide an exemption to any investment adviser to Private Funds so long as each such investment adviser acts solely as an adviser to Private Funds and has less than $150 million of AUM.

As a result of these changes to the exemptions under the Advisers Act, an investment adviser to one or more Private Funds (other than SBICs) that do not meet the definition of "venture capital fund" and that have $150 million or more of AUM will be required to register under the Advisers Act on or before the first anniversary of the enactment of the Dodd-Frank Act (which is likely to fall towards the end of July 2011).

The relatively low threshold of $150 million of AUM will capture many previously unregistered investment advisers to private equity and hedge funds. The broad potential for the definition of "venture capital fund," however, offers some possibility for exempting a significant number of investment advisers. Additionally, the intrastate exemption offers the possibility of relief from registration to investment advisers to certain smaller real estate funds. As was feared by many commentators, some investment advisory firms will be drawn offshore to avoid regulation in the U.S. under the Advisers Act and other laws.

STATE REGISTRATION FOR MID-SIZED INVESTMENT ADVISERS

In addition to the significant changes to exemptions described above, the Dodd-Frank Act amends the Advisers Act's preemption of state "blue sky laws" with respect to investment advisers. Currently, rules under the Advisers Act limit the states' regulatory authority to investment advisers with less than $25 million of AUM, and generally allow investment advisers with between $25 and $30 million of AUM to choose instead to register with the Commission. The Dodd-Frank Act, however, further precludes "mid-sized" investment advisers from registering with the Commission, leaving them subject to regulation by the state(s) in which they conduct their business. "Mid-sized" investment advisers include any advisers with between $25 million and $100 million AUM (or other higher amounts that the Commission may designate by rule), but excludes any adviser that would be required to register with 15 or more states as a result of not being registered under the Advisers Act.

RECORDING AND REPORTING REQUIREMENTS

The Dodd-Frank Act also modifies the reporting requirements for various types of investment advisers. First, it authorizes the Commission to require any registered investment adviser to comply with certain additional record-keeping and reporting obligations to the Commission. Importantly, the Dodd-Frank Act deems the records and reports of any Private Fund to which a registered investment adviser provides advice to be the records and reports of that investment adviser, such that the Private Fund's records (in addition to the registered investment adviser's records) will be subject to these requirements. These rules will require reporting on, among other things: (i) the amount of AUM and the use of leverage; (ii) counterparty credit risk exposure; (iii) trading and investment positions; (iv) valuation policies and practices of the fund; (v) types of assets held; (vi) any side arrangements whereby certain investors receive more favorable terms than other investors; (vii) trading practices; and (viii) any other information the Commission determines "is necessary and appropriate in the public interest and for protection of investors, or for the assessment of systemic risk."

Second, although the Dodd-Frank Act exempts investment advisers to venture capital funds and anticipates the exemption of investment advisers to Private Funds with less than $150 million of AUM from registration under the Advisers Act, it imposes new record-keeping and reporting obligations on unregistered advisers. In particular, the Dodd-Frank Act directs the Commission to issue rules requiring unregistered advisers to maintain and provide to the Commission such reports as the Commission deems "necessary and appropriate in the public interest and for protection of investors." The Dodd-Frank Act does not otherwise define the requirements for these records and reports.

The Dodd-Frank Act does address the confidentiality of any reports disclosed to the Commission. Specifically, it states that "[n]otwithstanding any other provision of the law, the Commission may not be compelled to disclose any report or information contained therein required to be filed with the Commission[.]" This confidentiality, however, is subject to the Commission's obligation to make disclosure to Congress, any self-regulatory organization or any other federal department or agency for matters within their jurisdiction. Any recipient of these reports will be subject to the same confidentiality requirements as the Commission, and will be exempt from the public disclosure requirements of the Freedom of Information Act (Section 552 of title 5, United States Code).

The Dodd-Frank Act also directs the Commission to take into account the level of systemic risk posed by "mid-sized private funds" (a term that is not defined in the Dodd-Frank Act) in prescribing regulation for registration and examination processes for registered investment advisers to such funds.

In addition to imposing these reporting requirements, the Dodd-Frank Act requires the Commission and the Commodity Futures Trading Commission to issue rules that define the form and content of the reports to be filed with the Commission.

CUSTODY OF CLIENT ACCOUNTS

The Dodd-Frank Act further authorizes the Commission to promulgate new rules that require a registered investment adviser to take steps to safeguard any client assets over which that adviser has custody. These steps could include verification of the assets by an independent public accountant. Currently, the Commission regulates a registered investment adviser's custody of client assets through Section 206(4)-2 of the Advisers Act. That section and Rule 206(4)-2 thereunder already require examination of those assets by an independent public accountant unless an exemption applies to that adviser.

CHANGES TO FINANCIAL ASPECTS OF THE DEFINITIONS OF "ACCREDITED INVESTOR" AND "QUALIFIED CLIENT"

The Dodd-Frank Act directs the Commission to create rules to adjust the definition of "accredited investors" for individuals for the purposes of the Securities Act of 1933, as amended. Under current rules, an individual will be considered an "accredited investor" if either: (i) that person has a net worth, or joint net worth with their spouse, that exceeds $1,000,000; or (ii) that person has income exceeding $200,000 in each of the two most recent years (or joint income with a spouse exceeding $300,000 for those years) and a reasonable expectation of the same income level in the current year.

First, the Dodd-Frank Act requires the Commission to adjust the net worth standard such that the net worth of an individual "accredited investor" excludes the value of such individual's primary residence. The threshold will remain at $1,000,000 for four years, after which the Commission will adjust that amount to account for inflation at least every four years.

Second, the Dodd-Frank Act authorizes the Commission: (i) to review the income standard to determine whether the requirements should be adjusted for the protection of investors, in the public interest or in light of the economy; and (ii) upon completion of such review, to make the necessary adjustments or modifications by notice or comment rule-making. Similarly, the Commission will adjust this definition at least every four years.

Finally, the Dodd-Frank Act requires the Commission to adjust any dollar amount used to exempt "qualified clients" from the prohibition on performance based compensation within Section 205(a)(1) of the Advisers Act in order to account for inflation. The Commission will adjust this amount not later than one year after enactment of the Dodd-Frank Act, and every five years thereafter.

STUDIES AND REPORTS COMMISSIONED BY THE DODD-FRANK ACT

In addition to the various amendments to the Advisers Act and the grants of Commission authority to issue rules thereunder, the Dodd-Frank Act also commissions five studies and reports by various government agencies.

Three of these studies and reports will be performed by the general accounting office ("GAO"). The first will focus on accredited investors in order to analyze the financial thresholds and other criteria to qualify for accredited investor status. The second will focus on the feasibility of forming a self-regulatory organization to oversee Private Funds. The third will focus on the costs of SEC rules 204-2 and 206(4)-2 regarding custody of client assets by investment advisers, and the costs associated with elimination of section (b)(6) of rule 206(4)-2 relating to operational independence. The Comptroller General will be required to submit these reports within three years, one year and three years of enactment of the Dodd-Frank Act, respectively.

The Dodd-Frank Act also commissions two studies and reports by the Office of Risk, Strategy and Financial Innovation on the state of short selling on national securities exchanges and in over-the-counter markets. The first will focus particular attention on the delivery (or failure to deliver) shares that have been sold short. The second will focus on the feasibility of real-time public reporting of the short sale positions of publicly listed securities. The Office of Risk, Strategy and Financial Innovation will be required to submit these reports within two years and one year of enactment of the Dodd-Frank Act, respectively.

CONCLUSION

The most immediate impact of the Dodd-Frank Act is that it requires many U.S. and certain non-U.S. investment advisers of private equity and hedge funds with more than $150 million of AUM to register under the Advisers Act on or before the first anniversary of the enactment of the Dodd-Frank Act. All registered investment advisers will be subject to heightened disclosure and reporting obligations to the Commission, as the Commission will determine pursuant to new and broad rule-making authority.

Investment advisers to “venture capital funds” and SBICs will remain exempt from registration with the Commission, but all unregistered investment advisers will be subject to new Commission reporting requirements. Consequently, the Commission’s final rule-making on the definition of “venture capital fund” will yet draw the attention (and hopes) of a significant spectrum of the private equity industry.

Meanwhile, investment advisers to real estate funds and certain non-U.S. investment advisers to Private Funds should speak to their U.S. securities law counsel to determine how the changes effected by the Dodd-Frank Act may affect their need to register with the Commission under the Advisers Act.

If you have any questions on these changes described in this memorandum, or other aspects of the Advisers Act, please contact one of the following partners of Morrison & Foerster’s Private Equity Fund Group.

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