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PHILLIPS NIZER LLP

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FUND FORMATION & INVESTMENT MANAGEMENT GROUP ALERT

PRESIDENT SIGNS FINANCIAL REFORM LEGISLATION INTO LAW

On July 21, 2010 President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or the "Act") into law. The Act provides for major changes to the financial services industry, including a number of new requirements that will impact investment advisers of private investment funds and separately managed accounts. The Act changes the ground rules of investor adviser registration. It will require certain advisers who were previously exempt from federal registration to register with the SEC and will require other investment advisers, previously registered with the SEC, to become subject to state regulation. In addition, the Act changes the "accredited investor" standard for natural persons, which is anticipated to impact private placements conducted by certain private funds and other business entities (public and private) pursuant to Regulation D under the Securities Act of 1933, as amended. The Act also provides for changes to be made to the "qualified client" standard under the Advisers Act, which will limit the ability of registered investment advisers to charge performance compensation. This alert focuses on these specific provisions of the Act and certain others that could affect private investment funds and their advisers. Except as described herein, the provisions of the Act covered by this alert will generally become effective one year from enactment.

Elimination of Private Adviser Exemption

- The Act eliminates the "private adviser exemption"[1] under Section 203(b)(3) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), thereby requiring investment advisers who meet the jurisdictional thresholds discussed below to register as an investment adviser under the Advisers Act, unless such adviser can satisfy one of the following exceptions:
  - Advisers whose clients are solely "private funds"[2] and who have less than $150 million in assets (in the aggregate) under management ("AUM") in the U.S.[3]
  - Foreign private advisers (i.e., an adviser (i) with no place of business in the U.S.; (ii) with aggregate AUM of less than $25 million[4] attributable to U.S. clients and investors in private funds advised by the adviser; (iii) with fewer, in total, than 15 U.S. clients or investors in private funds advised by the adviser; and (iv) that does not hold itself out to the public in the U.S. as an investment adviser, nor act as an investment adviser to any registered investment company or business development company).
  - Advisers solely to small business investment companies ("SBICs") licensed under Small Business Investment Act of 1958.
  - Advisers solely to "venture capital funds"[5] as such term is to be defined by the SEC.
  - Advisers to "family offices", as such term is to be defined by the SEC through rulemaking in accordance with previous exemptive orders and taking into account the broad range of organizational, management, and employment arrangements employed by family offices.
  - CFTC registered commodity trading advisors (i.e., advisers that are registered as commodity trading advisors with the Commodity Futures Trading Commission and that advise private funds are provided a conditional exemption from SEC registration if their advice is not predominantly related to securities). Such an adviser would become subject to dual registration if its investment activities changed to providing predominantly securities-related advice.

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- The Act amends the Advisers Act to change the threshold for exclusive SEC jurisdiction over investment advisers from $25 million AUM to $100 million.[6] Additionally, the Act creates a "mid-sized investment adviser" category for advisers with AUM between $25 million and $100 million[7] that are required to register with the state(s) in which they maintain a principal office.[8] With limited exceptions, mid-sized investment advisers that are subject to state registration requirements will not be permitted to register under the Advisers Act.[9]

For larger advisers, the elimination of the private adviser exemption from investment adviser registration will bring more managers of private funds within the ambit of SEC regulation, even with the increase in the AUM jurisdictional threshold. For smaller advisers, the elimination of the "private adviser exemption" coupled with the increase in the jurisdictional threshold are expected to cause the number of investment advisers subject to state supervision to increase significantly.[10] Those advisers required to deregister with the SEC as a result of the increase in the jurisdictional threshold (and who cannot otherwise avail themselves of the optional registration as a "mid-sized investment adviser") will have to ascertain the registration and compliance requirements of the states in which they maintain their principal office(s) or otherwise do business (particularly those states that have exemptions for advisers meeting the now eliminated federal "private adviser exemption", which would presumably remove an important state-level exemption as a result). Read literally, private fund advisers with AUM between $100 million and $150 million and that have one or more managed accounts would be required to register with the SEC, given that such adviser could no longer avail itself of the exemption for advisers solely to private funds with less than $150 million AUM. Similarly, an adviser to a venture capital fund that is also an adviser to a private fund and/or separately managed account with the requisite AUM would be required to register as an investment adviser under the Advisers Act.

These amendments to (and the new rules to be promulgated under) the Advisers Act will become effective on July 21, 2011.

Books and Records

Advisers to private funds that are now required to register under the Act will, as a result, be required to maintain records and file reports with the SEC for each private fund such adviser manages.[11] The form, content and disclosures required in the reports to be filed and the type of records and periods for which such records are to be maintained shall be determined through rulemaking. Such records and reports shall include the following information for each private fund: AUM, use of leverage (including off balance sheet), counterparty credit risk, trading practices, trading and investment positions, side-letters, valuation policies and practices, types of assets held, and any other information that the SEC, in consultation with the Financial Stability Oversight Council (the "Council"), determines necessary and appropriate for the protection of investors or for the assessment of systemic risk. In addition, the records and reports of any private fund managed by a registered investment adviser will be deemed to be the books and records of such adviser. The records will be subject to periodic and special examinations by the SEC, as determined through rulemaking.

The Act provides that confidential treatment will be given to such reports, subject to limited exceptions including sharing with the Council for the purposes of systemic risk regulation, with other U.S. Federal departments, agencies or self-regulatory organizations, or pursuant to Federal court order, among others. However, the Act provides that the SEC, the Council and any other department, agency or self-regulatory organization receiving such information, reports, documents, or records are exempt from the public information requirements under the Freedom of Information Act and any information ascertained by the SEC regarding a fund's proprietary information (such as investment and trading strategies or analytical or research methodologies) are subject to the same limitations on public disclosure as any facts ascertained during an examination.

Changes to "Accredited Investor" and "Qualified Client" Financial Thresholds

Effective midnight on July 21, 2010, the net worth standard for natural persons ($1 million in net assets) contained in Rule 501 of Regulation D excludes the value of such person's primary residence. Previously, the value of a natural person's primary residence (net of mortgages) was included in the net worth calculation. Absent further guidance from the SEC, presumably the new definition will only apply to new money invested in a private fund or other continuing offering, whether by a new investor or an existing investor, and there should be no need to recertify existing investors unless such investor makes an additional capital contribution. Based on this rationale, on the private equity side, if an investor has already made a capital commitment to the fund, the draw-down of capital by the fund from such investor should not require a recertification of the investor in accordance with the new definition. Over the next four

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years, the SEC is directed to review the other aspects of the "accredited investor" definition as they relate to natural persons (i.e., the annual income tests) to determine whether other adjustments should be made.[12] At the end of the initial four year period, and no less than every four years thereafter, the SEC will review and may adjust the entire accredited investor definition (including net worth thresholds) relating to natural persons for the protection of investors and to reflect the economy, generally. This is expected to limit the pool of investors that would otherwise qualify as "accredited investors" for smaller private investment funds relying on Section 3(c)(1) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), as well as private and public companies that conduct private placements under Regulation D to raise capital.

The Act also amends Section 205(e) of the Advisers Act to require the SEC to adjust for inflation any factor that uses a dollar amount test (i.e., the net asset threshold and AUM test) to determine "qualified client" status[13] under Rule 205-3 of the Advisers Act), no later than one year after enactment and every five years thereafter. Generally, performance-based compensation may not be charged to U.S. clients by registered investment advisers, unless each client or investor (in a private fund) is a "qualified client" (which definition includes "qualified purchasers" investing in so-called 3(c)(7) funds). This is expected to primarily impact smaller 3(c)(1) funds managed by registered advisers, which may have to choose between facing a more limited pool of potential investors that can satisfy the qualified client threshold or not being able to charge "prohibited" performance fees. It may also affect advisers to separately managed accounts.

Disqualification of Private Placements by Certain "Bad Actors"

The Act directs the SEC to issue disqualification rules within one year of enactment which would disqualify offers and sales of securities made under Rule 506 of Regulation D by certain "bad actors" that are (i) subject to final "bar" orders from state-securities commissions, banking, savings and credit union authorities, insurance commissions, and appropriate Federal banking agencies or final orders for deceptive, fraudulent or manipulative conduct within 10 years of the date of filing of the offer or sale; or (ii) convicted of any felony or misdemeanor in connection with the purchase or sale of securities or the making of false filings with the SEC.

Private Fund Self-Regulatory Organization

In addition, the General Accountability Office must study and report on the feasibility of forming a self-regulatory organization to oversee private funds and submit such report to the respective Senate and House committees within one year after enactment of the Act.

Fiduciary Duty for Broker-Dealers

The Act directs the SEC to continue to study the relative standards of care that apply to broker-dealers and investment advisers (and persons associated with both), including whether there are any regulatory or legal gaps related to "retail customers." A report on such study is due within six months of enactment of the Act. In addition, the Act amends Section 15 of the Securities Exchange Act of 1934, as amended, to give the SEC explicit rulemaking authority to impose a fiduciary duty on broker-dealers when providing personalized investment advice about securities to a retail customer.

The Volcker Rule

The Act prohibits any "banking entity" from sponsoring or investing in hedge funds or private equity funds, except: (i) in connection with the provision of bona fide trust, fiduciary, or investment advisory services by the banking entity; (ii) where the private fund is organized and offered only to persons that are customers of such services; (iii) where the banking entity makes de minimis investments in such private funds that do not exceed 3% of the total ownership interest of the fund (subject to certain seed investments where banking entity actively seeks unaffiliated investors and reduces its 3% ownership stake within one year of establishing such private fund) and the banking entity's interest in such funds do not exceed 3% of the banking entity's Tier 1 capital; (iv) where the banking entity does not share the same name or a variant thereof with the private fund; (v) where the banking entity does not guarantee, assume or otherwise insure the obligations of the private fund; and (vi) where no employee or director of the banking entity receives equity in the private fund (except those directly engaged in providing permitted services to the funds), among other things. To a limited degree, banking entities may provide prime brokerage services to private funds they

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are permitted to sponsor or invest in. "Nonbank financial companies" may sponsor or invest in hedge or private equity funds, subject to additional capital requirements and quantitative limits to be established by rulemaking. Another exception to the "Volcker rule" permits banking entities to make investments in SBIC funds or other investments designed to promote the "public welfare." In addition, there is an exemption for the sponsoring or acquisition of ownership interests in private funds outside the U.S., where the banking entity is not controlled by a U.S. banking entity and the interest is not offered or sold within the U.S. The "Volcker rule" will become effective only at the earlier of 12 months after the adoption of final regulations and two years after enactment of the Act, and banking entities covered by the rule will have an additional two year period to comply with the rule.

Regulations to be Promulgated under the Act

Much of the provisions of Act covered in this alert will be fleshed-out by regulations to be adopted by the SEC and the CFTC, in consultation with the Council. Such rulemaking initiatives are expected to play a significant role in shaping the practical application of the Act.

NOTES

1 The "private adviser exemption" from registration under the Advisers Act previously applied to advisers with fewer than 15 clients during the preceding 12 month period and who did not hold themselves out to the public as an investment adviser.
2 The Act defines "private fund" to cover all entities that would be deemed to be investment companies under the Investment Company Act, but for the application of Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. This does not capture real estate funds and commercial lending funds, which are exempt under 3(c)(5) of the Investment Company Act.
3 The Act provides for certain recordkeeping and annual or other reporting requirements for such exempted advisers (as determined by the SEC).
4 Or such higher amounts as the SEC may determine through rulemaking.
5 Although the Act exempts advisers to "venture capital funds", it provides for certain recordkeeping and annual or other reporting requirements for such advisers (as determined by the SEC).
6 In referring to the $25 million AUM threshold, Section 203A(a)(1) of the Advisers Act provides for such higher amounts as the SEC by rule deemed appropriate. Prior to the Act, Rule 203A-1 promulgated by the SEC pursuant to Section 203A(a)(1) provided that advisers with $25 million or more AUM were permitted to register with the SEC, while advisers with $30 million or more AUM were required to register with the SEC.
7 Both the $25 million and $100 million AUM thresholds may be adjusted to reflect such higher amounts as the SEC may determine through rulemaking.
8 Note that the Act did not change Section 203A(a)(1) of the Advisers Act, which provides that advisers with AUM less than $25 million will generally remain subject exclusively to state regulation.
9 Mid-sized investment advisers who would be required to register with 15 or more states may register with the SEC.
10 The Senate Committee on Banking, Housing, and Urban Affairs estimated that the number of advisers subject to state investment adviser regulation will increase by 28%. Kirsten Brost, *Summary: Restoring American Financial Stability*, Senate Committee on Banking, Housing, and Urban Affairs, Chairman Chris Dodd (D-CT), (March 15, 2010) <http://banking.senate.gov/public/_files/FinancialReformSummary231510FINAL.pdf>.
11 In prescribing regulations governing the registration and examination of advisers to "mid-sized private funds", the Act directs the SEC to consider the size, governance and investment strategy of such funds to determine the level of systemic risk they pose.
12 The Act also requires a General Accountability Office study of the appropriate financial thresholds or other criteria needed to qualify for accredited investor status and be eligible to invest in private funds within the first three years after enactment.
13 A qualified client is currently defined as (a) a natural person or a company that (i) has at least $750,000 under the management of the adviser, (ii) has a net worth of at least $1.5 million (inclusive of a spouse's net worth), or (ii) is a "qualified purchaser" (as defined under the Investment Company Act); or (b) a natural person who is an executive officer, director, trustee, partner of such adviser or an employee of such adviser engaged in investment related activities for such adviser or another company for at least 12 months.

To learn more about Phillips Nizer LLP's **Fund Formation & Investment Management Group** and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, please contact the attorneys named below.

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