Dodd-Frank: Outlook for U.S. and Foreign Investment Advisers, Private Funds, and Family Offices

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On July 21, 2010 President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law ("Dodd-Frank"). Dodd-Frank is the most comprehensive reform of the U.S. financial system since the 1930s. Included among its many reforms are amendments to the Investment Advisers Act of 1940, as amended (the "Advisers Act"), that change the regulatory landscape for U.S. and foreign investment advisers and private funds.

These amendments are contained in the *Private Fund Investment Advisers Registration Act of* 2010 (the "Act"). The Act tightens the registration requirements for fund managers and other investment advisers and increases the compliance obligations for private funds. Most of the substantive provisions of the Act do not become effective until July 21, 2011, and many aspects of the reform are left to the rulemaking of the Securities and Exchange Commission ("SEC"). Therefore, important details of the new regime will not be known until the SEC's publication of its implementing regulations. Nevertheless, the Act establishes the framework for the future regulation of private funds and domestic and foreign investment advisers. The affected fund managers and investment advisers should use the period until the implementation of Dodd-Frank to prepare for the upcoming changes.

Key Highlights

Key highlights of the changes to the Advisers Act include the following:

- *Elimination of the exemption* from Advisers Act registration for domestic investment advisers with less than 15 clients;
- Exemption from Advisers Act registration for *foreign private advisers* who (1) have no place of business in the United States, (2) have fewer than 15 U.S. clients or U.S. investors in private funds advised by them, (3) have less than $25 million in U.S. assets under management from private clients or in private funds advised by them, and (4) do not hold themselves out publicly as investment advisers in the United States or act as advisers to certain entities regulated under the Investment Company Act of 1940, as amended (the "Investment Company Act");
- Exemption of *family offices* from Advisers Act registration;
- Increase of the *threshold for federal registration* for many domestic investment advisers from $25 million to $100 million in assets under management;
- Registration requirement for investment advisers to a new category of *private funds* with at least $150 million in assets under management, other than advisers of *venture capital funds* or Small Business Investment Companies ("SBIC");
- New *disclosure, recordkeeping and reporting* requirements for advisers of private funds;
- Expansion of the requirement of registered investment advisers to disclose the *identity, investments or affairs of a client*;
- New SEC authorization to expand custody rule;
- New net worth test for *accredited investors* under SEC Rules 215 and Regulation D under the Securities Act, effective as of July 21, 2010; and
- Requirement to adjust the dollar thresholds for the *qualified client* standard under SEC Rule 205-3(d)(1) for inflation.

U.S. Investment Advisers

The Act eliminates the registration exemption for investment advisers with fewer than 15 clients within the past 12 months pursuant to Section 203(b)(3) of the Advisers Act for all domestic investment advisers. In addition, domestic advisers and managers of *private funds* will no longer be able to rely on the registration exemption for advisers with clients in a single state under Section 203(b)(1) of the Advisers Act.

The Act also changes the minimum threshold requirement for federal registration of investment advisers from $25 million to $100 million in assets under management for most investment advisers. The current $25 million threshold for federal registration continues to be available for advisers who would otherwise be required to register with 15 or more states, or who are not subject to state registration and examination in their home jurisdiction (e.g., New York). Mid-sized advisers with between $25 million and $100 million in assets under management who are subject to registration and examination in the state in which they maintain their principal place of business may no longer register with the SEC, but will instead have to register with the appropriate state authority. The SEC maintains its authority to increase the $25 million threshold for federal registration of mid-sized investment advisers and is given authority to increase the $100 million threshold for the general federal registration requirement.

Advisers to Private Funds

The Act creates a new category of *private funds.* Private Funds are defined as funds who would be investment companies under the Investment Company Act, but for the exceptions provided in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. These exceptions are generally relied upon by U.S. and foreign venture capital funds, private equity funds, hedge funds and private funds of funds in order to avoid registration under the Investment Company Act. Because under the existing law neither the funds nor their advisers are required to register with the SEC, these funds are currently not subject to SEC oversight.

The Act will bring private funds with at least $150 million in assets under management in the United States under SEC supervision by requiring advisers and managers of these funds to register as investment advisers with the SEC. Advisers who *only* advise (1) *venture capital funds,* or (2) SBICs are exempt from this registration requirement. Advisers to private funds that are registered as a commodities trading adviser with the Commodity Futures Trading Commission ("CFTC") are exempt from registration under the Advisers Act unless they become "predominantly" involved in securities-related advice. It is important to note that the increased threshold for federal registration and the exemptions for advisers to venture capital funds and SBIC is only available to advisers who *solely* advise private funds. Advisers who advise private funds and individual clients (e.g., managed accounts) will be subject to the general registration requirements under the Advisers Act.

The Act leaves many aspects of the new regime to regulation by the SEC, including the definition of the term *venture capital fund*. In implementing the registration requirements for advisers to *mid-sized private funds* - a term to be defined by the SEC - the Act requires the SEC to consider whether the size, governance, and investment strategy of these funds poses a systemic risk. The SEC is also asked to provide for registration and examination procedures of advisers to mid-sized funds that reflect the level of systemic risk posed by these funds.

Foreign Private Advisers

The Act provides for a limited exemption from the registration requirement for *foreign private advisers.* A foreign private adviser is an investment adviser who (a) has no place of business in the United States, (b) has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the investment adviser, (c) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the foreign

investment adviser of less than $25 million (or such higher number as the SEC may deem appropriate), and (d) neither holds itself out publicly in the United States as an investment adviser, nor acts as an investment adviser to an investment company registered under the Investment Company Act or a business development company pursuant to Section 54 of the Investment Company Act.

For foreign investment advisers who are not advisers to private funds, Dodd-Frank reflects the current law with respect to their registration requirement under the Advisers Act. For foreign advisers and managers of private funds, the Act expands the registration requirement. For example, under current law, a foreign adviser could treat an offshore fund as a non-U.S. client for purposes of determining whether the adviser would be required to register with the SEC. Under the new law, the adviser would have to look through private funds established outside the United States to determine whether the fund has U.S. investors or assets under management attributable to U.S. investors. The term "investors" is not defined for purposes of this exemption and it is not clear whether an investor participating in multiple funds sponsored by the same adviser would be counted separately in determining the aggregate number of U.S. investors.

The structure of foreign managers of private fund families with U.S. investors will have to be carefully planned to avoid registration with the SEC, especially if a foreign fund manager advises either both private funds and individual investors (managed accounts) or different types of private funds. For example, a foreign adviser who solely advises private funds with more than 15 U.S. clients and/or more than $25 million in U.S. assets under management would still be exempt from the requirement to register as an investment adviser if these private funds have less than $150 million in assets under management in the United States. However, a foreign investment adviser who advises both individual clients and private funds and has $25 million or more in assets under management - either from private U.S. clients or from U.S. investors in private funds managed by the foreign investment adviser - will be required to register with the SEC even if the U.S. assets under management in private funds advised by the foreign investment adviser are below $150 million.

When evaluating the benefits of Advisers' Act registration, foreign advisers should be sensitive to the expanded requirement to disclose the identity, investments or affairs of clients introduced by Dodd-Frank. See *"Expanded Disclosure of Client Information"* below.

Family Offices

The Act exempts family offices from the provisions of the Advisers Act, but leaves the definition to the SEC. However, the SEC's authority is limited insofar as the definition must (1) be consistent with the SEC's existing rules exempting family offices from the Advisers Act, (2) recognize the diversity of organizational, management, and employment structures of family offices, and (3) respect the grandfathering of advisers who were not required to register as investment advisers on January 1, 2010 solely because they were engaged prior to January 1, 2010 in giving investment advice to (a) officers, directors or employees of a family office who are *accredited investors* pursuant to Regulation D under the Securities Act, (b) any company owned exclusively and controlled by members of the family of the family office, or (c) certain registered investment advisers to the family office. Family offices by virtue of this grandfathering rule will be subject to the anti-fraud provisions of Section 206(1),(2) and (4) of the Advisers Act.

New Disclosure and Recordkeeping Requirements for Private Funds

The Act adds a new Section 204(b) to the Advisers Act that requires registered advisers of private funds to maintain such records and provide such reports to the SEC as are "necessary and appropriate" in the public interest or for the protection of investors, or for the purpose of enabling the newly created Financial Stability Oversight Council (the "Council") to assess the systemic risk posed by a private fund. These

reports and records will be made available to the Council. Specifically, records required to be maintained for each private fund advised by a registered investment adviser include a description of the following:

- The amount of assets under management and use of leverage (including off-balance sheet leverage);
- Counterparty credit risk exposure;
- Trading and investment positions;
- Valuation policies and practices of the fund;
- Types of assets held;
- Side arrangements or side letters; and
- Trading practices.

The Act also authorizes the SEC to specify other information that the SEC, in consultation with the Council, determines to be necessary for the purposes set forth above. With respect to this information, the Act authorizes the SEC to differentiate among different classes of fund advisers based on the type or size of the private funds advised. The Act leaves the details of the recordkeeping and reporting obligations of registered private fund advisers to SEC regulation and authorizes the SEC to conduct inspections and other examinations that the SEC may deem necessary and appropriate to further the purpose of the new recordkeeping and reporting requirements. The Act also instructs the SEC to require advisers to venture capital funds or private funds with less than $150 million to maintain such records and provide such reports as the SEC determines to be necessary or appropriate in the public interest or for the protection of investors.

Confidentiality of Fund Information

The SEC must share the information contained in the records and reports required under the new Section 204(b) with the Council. Both the SEC and the Council are required to maintain the confidentiality of this information, and the information contained in these records and reports is not subject to the federal Freedom of Information Act. Disclosure of this information may not be compelled except by (1) Congress under a confidentiality agreement, (2) any other federal authority or self-regulatory organization (e.g., FINRA) for purposes within the scope of its jurisdiction, or (3) a U.S. court in an action brought by the United States or the SEC. Accordingly, while information contained in these records and reports may be disclosed in an enforcement action brought by the SEC or another federal authority, private parties have no right to access this information. The extent of the protection of information submitted to the Office of Financial Research ("OFR") created to gather information from both regulated and unregulated financial market participants, is, however, unclear. Dodd-Frank specifically subjects information submitted to the OFR to the Freedom of Information Act, creating a conflict with the provisions of the new Section 204(b) of the Advisers Act.

The public disclosure of *proprietary information* - including investment or trading strategies, analytical or research methodologies, and trading data - will be subject to the limitations under Section 210(b) of the Advisers Act that apply to information obtained in SEC examinations. Pursuant to this provision, proprietary information may not be disclosed to any person outside of the SEC, unless (1) the information is obtained in a public hearing, or (2) the information is requested by either House of Congress.

Expanded Disclosure of Client Information

The Act expands the circumstances in which the SEC may require disclosure of the *identity, investments, or affairs of a client*. Under current law, the SEC may require disclosure of this information only if necessary or appropriate in an enforcement proceeding or investigation. In the future, client information must also be disclosed to the SEC for purposes of the assessment of potential systemic risks. It remains to be seen whether future SEC rulemaking and practice will establish sufficient safeguards to prevent this

provision from providing the SEC, and possibly other federal authorities, with a backdoor access to confidential client information.

New Custody Rule

Pursuant to new Section 233 of the Advisers Act, the SEC may require registered investment advisers to take such steps to safeguard client assets over which they have custody, including verification of these assets by an independent public accountant.

Accredited Investor Status

One of the few substantive provisions of the Act that became effective upon its enactment was a new net worth test for a natural person to qualify as an *accredited investor*. Accredited investor status is relevant for purposes of determining the availability and disclosure requirements of the private placement exemption from the registration requirements of securities offerings in reliance on the safe harbor provided by Rule 506 of Regulation D under the Securities Act. Under current SEC Rules 215 and 501 of Regulation D, a natural person qualifies as an accredited investor if (1) his or her annual income exceeds $200,000 or the joint income with his or her spouse exceeds $300,000 in each of the two most recent years and he or she has a reasonable expectation of reaching the same income level in the current year, or (2) his or her individual net worth or joint net worth exceeds $1 million.

Effective as of July 21, 2010, the value of a natural person's primary residence must be *excluded* from his or her net worth for purposes of his or her qualification as an accredited investor under applicable SEC rules. For a period of four years from the date of the enactment of Dodd-Frank, this net worth standard, as amended, will remain at $1 million. During this period, the SEC *may* review and adjust the requirements for accredited investor status, except for the net worth test. After four years, and every four years thereafter, the SEC *must* review the accredited investor status under Rule 215 in its entirety and *may* by rule adjust the definition as the term applies to natural persons. The fact that the Act specifically requires that the SEC act through its regular rulemaking process guarantees that interested parties will have an opportunity to comment on any proposed changes to the accredited investor status for natural persons.

Hedge funds, private funds of funds and other issuers with ongoing private offerings of securities should amend their offering documentation to ensure compliance with the new net worth standard for investors who participate in the offering after July 21, 2010.

Qualified Client Standard

Registered investment advisers may only charge performance fees from *qualified clients*. Pursuant to SEC Rule 205-3(d)(1) under the Advisers Act, qualified clients include, among others, natural persons or companies with at least $750,000 under the management of the investment adviser or a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000. The Act provides that the SEC must by order adjust for inflation these thresholds no later than one year after the enactment of the Act, and then every five years thereafter. Any adjustment that is not a multiple of $100,000 must be rounded to the nearest multiple of $100,000.

This requirement will increase the threshold for investment advisers, including registered private equity and hedge fund managers, to be able to charge performance fees. Existing hedge funds will be required to amend their fund documentation accordingly.

Implications of other Provisions of Dodd-Frank for Investment Advisers

In addition to the amendments to the Advisers Act, investment advisers are affected by other provisions of Dodd-Frank, including the following:

- The Council has the authority to designate any U.S. or foreign *nonbank financial company* as systemically important with the effect that this institution would become subject to *Federal Reserve* regulation with respect to systemic risks. The term nonbank financial company is defined as a company, other than a bank holding company, that is predominantly engaged in financial activities. This appears to include investment advisers, fund managers, private equity funds, and hedge funds that could pose a systemic risk to the U.S. financial systems because of their size or activities.
- The so-called *Volcker Rule* restrictions on fund sponsorship and investment activities of banks, bank holding companies, and certain other financial institutions will likely lead to divestiture by these institutions of investments in sponsored funds and certain other fund investments. This government-mandated change in the private fund market will create opportunities for new market participants as banks spin-off their private fund business to the managers of these funds and for fund managers who can assume management of assets that have to be divested by banks. In certain circumstances, this will also create problems for private fund managers as banks are required to withdraw their investments from these funds.
- Dodd-Frank requires federal bank regulators and the SEC to examine and impose restrictions on incentive compensation paid by *covered financial institutions*, including investment advisers, with assets under management of at least $1 billion.
- Dodd-Frank authorizes the SEC to examine and, if appropriate, regulate sales and compensation practices, and conflicts of interests of brokers, dealers, and investment advisers.
- *Financial Companies* regulated by a federal financial regulator (including the SEC) with total consolidated assets in excess of $10 billion are required to undergo annual stress tests. Although Dodd-Frank does not define the term *financial company*, it is possible that this requirement would apply to investment advisers that meet the $10 billion asset standard. SEC regulations implementing this requirement should clarify the extent to which investment advisers will be subject to this requirement.

Upcoming SEC Rulemaking and Future Initiatives

The Act leaves many key definitions and important details to regulation by the SEC, and in some cases to the CFTC, including the definition of the term *venture capital fund* and the form and content of the new Section 204(b) reports. Many of these rules must be issued within twelve months of the enactment of the Act. Accordingly, intense regulatory activity should be expected during the next year. The full impact of the changes to the Advisers Act on investment advisers and private funds will depend on these rules and regulations and future initiatives by the SEC, and possibly Congress.

On July 27, 2010, the SEC took the unusual step of inviting the public to comment on the various rulemaking requirements and initiatives imposed by the Act prior to the commencement of the SEC's formal rulemaking process. Comments may be submitted by email or by web posting on the following web site: http://www.sec.gov/spotlight/regreformcomments.shtml. In her public statement announcing this initiative, SEC Chairman Mary Shapiro made it clear that this informal process is not meant to encroach on the formal public commenting process for its proposed rules and regulations that commences with the publication of the proposed rule or regulation in the Federal Register.

The Act also commissions various reviews and studies by the SEC and other federal authorities, including studies by the Comptroller General of the United States of the accredited investor standard and of the feasibility of a self-regulatory organization to oversee private funds. These reviews and studies in turn may lead to new regulatory or legislative initiatives in the future.

What Should Investment Advisers and Fund Managers Do Now?

Although most provisions of the Act will not become effective before July 21, 2011, and in many cases the impact of the Act depends on regulations implementing the Act, investment advisers and fund managers can and should begin the process of analyzing the potential impact of the Act on their operations. Specifically,

- Fund managers with ongoing private offerings who have not done so already should amend the offering documentation to ensure compliance with the amended net worth test for *accredited investors* who are natural persons.
- Unregistered investment advisers and managers of private funds should analyze whether the changes to the Advisers Act will or may require registration under the Advisers Act and how such registration will affect their operations and compliance efforts.
- Registered managers of private funds should analyze the impact of the new recordkeeping and reporting requirements for investment advisers to private funds on their operations and determine whether alternative structures may be available to reduce the effects of these requirements.
- Unregistered foreign investment advisers and fund managers should analyze whether they may continue to avoid registration under the Advisers Act under the *foreign private adviser* exemption introduced by the Act, and, if not, whether changes to their business model or structure could avoid such registration or how registration would affect their operations and compliance efforts.
- Family offices may want to review their structure to ensure compliance with current SEC practice exempting them from Advisers Act registration and analyze whether future SEC rules could have an impact on their structure.
- Based on an analysis of their specific situation, domestic and foreign investment advisers and fund managers should establish strategies as to how to adjust their structure and/or operations to the changes to the Advisers Act and the forthcoming regulations implementing these changes.

During the implementation phase of the Act, investment advisers and fund managers should keep abreast of developments in the rulemaking process, consult with legal counsel to obtain a better understanding of the new rules, plan and, if necessary, implement changes to their structure and/or operations, and, to the extent possible, update their compliance programs in response to the new regulations.

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Wuersch & Gering LLP is keeping abreast of these changes and intends to periodically publish updates on the implementation of the legislation discussed herein.

This summary is intended to provide general information only on the matters presented. It is not a comprehensive analysis of these matters and should not be relied upon as legal advice. If you have any questions about the matters covered in this publication, please contact:

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