July 23, 2010

Dodd-Frank Act Impacts Investment Advisers, Private Funds and Private Securities Offerings

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was signed into law by President Obama on July 21, 2010. Among the many financial regulatory areas it affects, the Dodd-Frank Act will have a significant impact on the registration and regulation of investment advisers and private funds, including hedge, private equity and venture capital funds and upon offerings of securities under Regulation D under the Securities Act of 1933, as amended (the "Securities Act"). The following is a summary of some of the most significant changes mandated by the Dodd-Frank Act.

REVISED REGISTRATION AND EXEMPTION SCHEME FOR INVESTMENT ADVISERS

New Level of Assets Under Management ("AUM") for Eligibility to Register with SEC

The National Securities Markets Improvement Act ("NSMIA"), enacted in 1996, created a bifurcated approach to the regulation of investment advisers between the federal government and the states in order to allocate responsibility generally based upon the size of the adviser. Under that regulatory scheme, as a general rule, only investment advisers managing at least $25 million in AUM could *opt* to register with the Securities and Exchange Commission ("SEC") and advisers managing at least $30 million in AUM were *required* to register with the SEC, in each case absent an exemption. Notwithstanding the AUM tests, and unless an exemption from registration was available, an adviser was required to register with the SEC if, upon submission of its application for SEC registration the adviser was required by the laws of 30 or more states to register as an investment adviser, and thereafter would have, but for the AUM test, been required by the laws of at least 25 states to register as an investment adviser (the "Multi-State Adviser Test").

The Dodd-Frank Act changes the above allocation of registration authority, by prohibiting SEC registration to an adviser that:

- is required to be registered with the state securities regulator in the state where it maintains its principal office and place of business, and if registered, would be subject to examination as an investment adviser by such regulator; and

- has more than $25 million but less than $100 million (or such higher amount as determined by the SEC by rule) in assets under management.

The Dodd-Frank Act also revises the Multi-State Adviser Test so that if an adviser would be required to register with 15 or more states due to the $100 million assets under management tests, the adviser may register with the SEC.

The new AUM standard will come into effect one year following enactment of the Dodd-Frank Act.

Observation: The revised AUM thresholds will require many SEC-registered private fund advisers currently registered with the SEC will be required to convert to state registration. This will create a corresponding increase in the number of advisers for whom state regulators will assume primary responsibility.

Elimination of Exemption for Advisers with Fewer than 15 Clients

For advisers who provide investment advice on a limited basis, the principal exemption from registration with the SEC has been the exemption for "private" investment advisers. Under that exemption, an investment adviser that had fewer than 15 clients during the course of the preceding 12 months and did not hold itself out to the public as an investment adviser was exempt from registration. This exemption was widely relied upon by advisers to private funds since each fund counted as only one client.

Effective 12 months following its enactment, the Dodd-Frank Act eliminates this exemption and replaces it with a limited "foreign private adviser exemption" which is applicable to an adviser that has:

- no place of business in the United States;
- in total, fewer than fifteen clients (with an investment fund and its investors each counting as one client) in the United States;
- aggregate AUM attributable to clients (including both investment funds and their investors) in the United States of less than $25 million, or such higher amount as the SEC may deem appropriate; and neither:
- holds itself out generally to the public in the United States as an investment adviser;
- acts as an investment adviser to any investment company registered under the Investment Company Act of 1940, as amended (the "Investment Company Act"); nor
- acts as a company that has elected to be a business development company pursuant to the Investment Company Act and has not withdrawn such election.

Observation: The "under 15 clients exemption" has been the principal basis on which advisers to private funds have avoided SEC registration. The intrastate exemption, the elimination of which is discussed below, was also another basis for avoiding SEC registration. Advisers to some private funds then also sought to avoid state registration based upon the argument that it is not "in the business of providing investment advice" because the adviser is acting solely as the general partner of the fund, and because it does not hold itself out to the public as offering investment advice. Thus, some funds were effectively unregulated by either the SEC or the states. As a result of the elimination of the under 15 clients and intrastate exemptions, most advisers to private funds will no longer be deemed to have fewer than 15 clients and will be required to register with the SEC, subject to meeting the standards for SEC registration described above.

What to do now: Even though this provision of the Dodd-Frank Act is not effective until July 2011, advisers who can anticipate SEC registration should recognize that registration will bring with it a host of additional obligations including the need to adopt compliance policies and procedures, an insider trading policy, a code of ethics, recordkeeping obligations, the requirement of a chief compliance officer and others. All of these requirements mean that significant planning, effort and expense will be required to meet the ongoing obligations that are coincident with SEC registration and therefore advisers should begin preparing for registration now.

New Exemption for Venture Capital Funds

The Dodd-Frank Act includes an exemption from registration with the SEC for investment advisers to one or more "venture capital funds," which term is to be defined by SEC rulemaking within a year of enactment. Advisers to venture capital funds will, however, be required to maintain records and provide annual or other reports as determined by the SEC.

Exemption for Private Fund Advisers with Less than $150 Million in AUM

The SEC is required to provide an exemption from registration for an adviser which acts solely as an adviser to private funds and that has less than $150 million in AUM. This exemption requires that the private fund adviser is otherwise subject to SEC registration. A "private fund" is defined as an issuer that would qualify as an "investment company" under Section 3 of the Investment Company Act, but for the exemptions under Sections 3(c)(1) and 3(c)(7). Such exempt private fund advisers are still required to maintain records and provide annual or other reports, as determined by the SEC.

Registration and Examination of Mid-sized Private Fund Advisers

In prescribing registration and examination requirements for "mid-sized private fund advisers," the SEC is required to consider size, governance, and investment strategy registration and examination procedures to determine if they pose systemic risk. The Act does not define the term "mid-sized private funds."

Exemption from Registration for "Family Offices"

Within one year following enactment, the SEC is required to provide an exemption from registration for "family offices" which term is not yet defined. The definition of "family office" to be determined by the SEC must (1) be consistent with the SEC's previous exemptive policy for family offices; (2) recognize the range of organizational, management, and employment structures of family offices; and (3) not exclude any person from the definition of "family office" who was not registered or required to be registered on January 1, 2010, solely because such person provided investment advice before then.

Intrastate Exemption Limited

Another exemption that prior law provided for private advisers was for those advisers, (i) all of whose clients were residents of the state of the adviser's principal office and place of business, and (ii) who did not furnish advice, analyses or reports with respect to securities listed or admitted to enlisted trading privileges on any national securities exchange. The Dodd-Frank Act eliminates this exemption for any adviser to a "private fund" (see definition above).

RECORDS AND REPORTS REQUIRED

The Dodd-Frank Act authorizes the SEC to require SEC-registered advisers to maintain records and provide reports with respect to the private funds that they advise. The records that must be maintained, and which will be subject to examination by the SEC, include the following:

- The amount of AUM and the use of leverage, including off-balance-sheet leverage;
- Counterparty credit risk exposure;
- Trading and investment positions;
- Valuation policies and practices of the funds;
- Types of assets held;
- Any side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors;
- Trading practices; and
- Such other information as the SEC, in consultation with the Financial Stability Oversight Council, deems necessary.

REGULATION D CHANGES

Definition of Accredited Investor Changed to Eliminate Primary Residence from Net Worth

Regulation D is a safe harbor from the registration requirements under the Securities Act for securities offerings. Among other things, Regulation D allows an unlimited number of accredited investors to invest in a private offering. Because of NSMIA's preemption of state regulation of certain Regulation D offerings directed at accredited investors, it has been a favorite exemption of issuers. The definition of "accredited investor" under Rule 501 of the Securities Act has remained unchanged since its adoption in 1982. That definition allowed the inclusion of an investor's primary residence in calculating whether the investor had the required minimum net worth of $1 million to qualify as an accredited investor. The Dodd-Frank Act changes the definition to <u>exclude</u> an investor's principal residence from the net worth calculation. Significantly, this change is effective immediately upon enactment of the Dodd-Frank Act into law and contains no transition or grandfather provision. Further, the SEC has expressed its view that pending implementation of the changes to the SEC's rules required by the Dodd-Frank Act, the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded but indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth.

The Dodd-Frank Act also directs the SEC to review the entire accredited investor definition, as it applies to natural persons, four years after enactment and at least once every four years thereafter.

Observation: These changes mean that the universe of potential investors for securities offerings targeted toward accredited investors will be reduced significantly since the primary residence is frequently a significant component of the net worth of a prospective investor.

What to do now: Because this change is effective upon enactment of the Dodd-Frank Act, issuers should immediately review and update their offering documents and procedures to update the definition of "accredited investor."

Disqualification of "Bad Actors"

A criticism that state regulators have had about Regulation D is that persons who had been found to have violated securities laws ("bad actors") were nevertheless not constrained from relying on Regulation D to continue making exempt securities offerings. The bad actors disqualification is a common feature of state securities laws which often condition the availability of a registration exemption on an absence of bad actor status. The Dodd-Frank Act addresses the concern of state securities regulators by directing that within one year of enactment, the SEC adopt rules to match the bad actor disqualification provisions of Regulation A under the Securities Act. Regulation A is an exemption from registration for sales of up to $5 million of securities during any 12-month period. Regulation A disqualifies persons who have been sanctioned by state securities commissions or authorities and persons who have been convicted of a securities-related felony or misdemeanor from relying upon that exemption.

LIMITATIONS ON ADVISERS' PERFORMANCE FEES

Section 205(a)(1) of the Investment Advisers Act of 1940 (the "Advisers Act") prohibits advisory contracts that include a performance fee. Under its rulemaking authority, the SEC adopted Rule 205-3 which permits performance fees for "qualified clients." Until now, that prohibition has been inapplicable to advisers who have been exempt from registration in reliance upon the exemptions provided by Section 203(b) of the Advisers Act. The Dodd-Frank Act, by eliminating the most popular exemptions, will now effectively bring most private fund advisers within the prohibition of Section 205(a)(1).

What to do now: Going forward, private fund advisers will need to be diligent in confirming that their fund investors meet the definition of "qualified clients" to be able to impose a performance fee and to adjust their offering documentation accordingly.

ADJUSTMENT OF DEFINITION OF QUALIFIED CLIENT FOR INFLATION

As seen from immediately above, the definition of "qualified client" is important in identifying those persons to whom advisers may charge performance fees. "Qualified client" is defined in Rule 205-3(d)(1) under the Advisers Act. The Dodd-Frank Act directs the SEC to adjust for inflation the "qualified client" standard of $750,000 AUM and $1.5 million net worth within one year of enactment and every five years thereafter.

FIDUCIARY DUTY OF BROKER-DEALERS

Currently, investment advisers owe a fiduciary duty to their clients while broker-dealers, who often perform the same advisory functions, are held to a lower suitability standard. The Dodd-Frank Act directs the SEC to continue to study the relative standards of care that apply to broker-dealers and investment advisers, respectively, and authorizes the SEC to impose a fiduciary duty on broker-dealers, while not mandating a fiduciary duty for broker-dealers.

STUDIES AND REPORTS

The Dodd-Frank Act is breathtaking in its scope. Aside from changes reported above and many more which are taking effect and are scheduled to take effect, it has been calculated that it requires 243 rulemakings, 67 studies and 22 new periodic reports of which the SEC will be required to conduct 95 rulemakings, 17 studies and 5 new periodic reports. Obviously, it is important for interested observers to stay alert for the release of these reports, studies and especially rulemakings since it is certain that the regulatory landscape will continue to evolve and change.

For more information, please feel free to contact your Butzel attorney, the authors listed below or other attorneys of the Investment Management Practice Group.

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