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Private Investment Funds Alert

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The New Era of Regulation Under the Dodd-Frank Act: A Compliance Guide for Investment Advisers and Private Investment Funds

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") was enacted into law on July 21, 2010. Title IV of the Dodd-Frank Act, the Private Fund Investment Advisers Registration Act of 2010 (the "**Act**") ushers in a new era of regulation and significantly alters the registration and reporting requirements under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). The most significant changes affecting hedge fund and private equity fund investment advisers include but are not limited to:

- Repealing the current private adviser exemption[1] under Section 203(b)(3) of Advisers Act;
- Setting new asset thresholds for federal registration of investment advisers;
- Directing the Securities and Exchange Commission ("**SEC**") to create an exemption from federal registration for advisers who advise only private funds[2] and have assets under management of less than $150 million;
- Eliminating the intrastate exemption for advisers to private funds;
- Excluding "family offices" from the definition of investment adviser based on prior SEC exemptive relief; and
- Adjusting the accredited investor definition *(effective July 21, 2010)*.

The effective date of the Act is **July 21, 2011**, except as otherwise provided in the Act. However, an investment adviser to a private fund may register during the one-year transition period, subject to SEC rules.

Repeal of the Private Adviser Exemption

The repeal of the private adviser exemption leaves many private fund investment advisers without an exemption to rely upon to avoid registration under the Advisers Act. As such, many private fund investment advisers, including foreign advisers with U.S. clients, may be required to register with the SEC for the first time. Additionally, many registered investment advisers that do not meet the revised eligibility threshold will be required to de-register with the SEC and become regulated by the States. The Act does, however, provide a series of exemptions from the registration requirements of the Advisers Act, based upon assets under management or the type of private fund, as detailed below.

[1] The private adviser exemption was the exemption typically relied upon by hedge fund and private equity fund investment advisers to avoid registration under the Advisers Act. An investment adviser was previously exempt from registration under the private adviser exemption if the adviser (i) did not generally hold itself out to the public as an investment adviser; (ii) had fewer than 15 clients in the preceding 12 months and (iii) did not act as an adviser to registered investment companies or business development companies.

[2] As used in the Act, the term "**private fund**" means an issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), but for section 3(c)(1) or 3(c)(7) of the Investment Company Act.

New Asset Thresholds for Federal Registration

- *Asset Threshold For Federal Registration Raised To $100 Million*. Section 203A(a) of the Advisers Act currently provides that no investment adviser that is regulated within the state in which it maintains its principal place of business may register with the SEC unless it has assets under management ("**AUM**") of $25 million or such higher amount as the SEC, by rule, deems appropriate.[3] The Act raises the threshold of AUM required for SEC registration to $100 million or such higher amount as the SEC may, by rule, deem appropriate. Advisers that are currently registered with the SEC and have between $25 million and $100 million will have to de-register and become regulated by the state of their principal place of business. ***Accordingly, investment advisers to managed accounts and private funds with AUM above $100 million will be required to register with the SEC by no later than July 21, 2011***.

- *Multi-State Registered Investment Advisers May Register With The SEC*. Investment advisers that are registered in 15 or more states and have between $25 million and $100 million AUM are permitted under the Act to register with the SEC.

- *Elimination Of Intrastate Advisers Exemption For Investment Advisers To Private Funds*. The exemption for intrastate advisers under Section 203(b)(1) of the Advisers Act has been amended to limit eligible advisers to those who do not advise private funds. Accordingly, all other intrastate advisers (other than those who advise private funds) are exempt from registration with the SEC.

Exemptions from Registration under the Act

- *Advisers Managing Only Private Funds With Less Than $150 Million AUM*. The Act requires the SEC to provide an exemption from registration for advisers that manage only private funds and have AUM of less than $150 million. Such exempted advisers will still be required to maintain such records, and provide the SEC with such annual or other reports, as the SEC determines necessary or appropriate to protect investors. The SEC is also directed to provide registration and examination procedures for "mid-sized private fund advisers" commensurate with the amount of systemic risk such advisers pose, if any. The SEC will take into account the size, governance and investment strategy of the mid-sized funds advised by such mid-sized private fund advisers.

- *Advisers To Venture Capital Funds*. Advisers to one or more venture capital funds will not be subject to registration under the Act. Not later than **July 21, 2011**, the SEC is directed to issue final rules defining the term "venture capital fund" for purposes of this exemption. Venture capital private fund advisers will be subject to the same records and reporting requirements as described immediately above. Although there is currently no definition of "venture capital fund" or anything similar in the SEC statutes or regulations, we believe that the SEC may well look to the concept of a venture capital operating company (VCOC) in the Department of Labor ("**DOL**") plan asset regulations under the Employee Retirement Security Act of 1974 for further guidance on crafting a "venture capital fund" definition. The DOL plan asset regulations define a "venture capital operating company" as an entity where "at least 50 percent of its assets (other than short-term investments pending long-term commitments), valued at cost, are

[3] Investment advisers that manage less than $25 million AUM will continue to be prohibited from registering with the SEC, and accordingly, subject to registration in, and examination by, the state in which they have their principal place of business.

invested in venture capital investments" and the entity is able to exercise management rights with respect to one or more operating companies in which it invests. "Venture capital investments" are defined under the DOL plan asset regulations as investments in operating companies where the investor has management rights, such as the ability to substantially participate in, or substantially influence the conduct of, the management of the operating company. This approach is similar to the approach used by the State of California to exempt from state registration and certification investment advisers that advise venture capital funds. The SEC previously addressed the other side of this issue when it attempted to regulate hedge funds and defined "private investment funds" as those funds where the investors are able to redeem a portion of their ownership interests within two years after the date of purchase, which effectively excluded venture capital funds and similar long-term, illiquid, closed-end private investment funds.

If the SEC adopts a similar or identical approach to the DOL and the State of California, investment advisers to not only traditional venture capital funds, but to other illiquid private investment funds, such as mezzanine funds, could be exempt from registration.

- *Exclusion Of Family Offices From the Definition of Investment Adviser*. The Act specifically excludes from the definition of "investment adviser" the term "family office," and accordingly, a family office would not be subject to registration under the Advisers Act. The SEC is directed to create a rule to define the term "family office" which must be consistent with previous SEC exemptive policy. In addition, under a grandfathering provision, the definition of "family office" must not exclude any person who was not registered or required to be registered on January 1, 2010 because such person provides investment advice to certain categories of investors.[4] Notwithstanding the foregoing, family offices that are deemed as such by virtue of a grandfathering provision will in fact be an investment adviser for purposes of the antifraud provisions in paragraphs (1), (2) and (4) of Section 206 of the Advisers Act.

- *Advisers To Small Business Investment Companies*. Advisers to small business investment companies licensed under the Small Business Investment Act of 1958 (other than business development companies regulated pursuant to Section 54 of the Investment Company Act) are exempt from SEC registration.

- *Registered Commodity Trading Advisers*. Advisers that are registered as Commodity Trading Advisers with the Commodities Futures Trading Commission and advise a private fund will be exempt from SEC registration unless their business becomes predominately securities-related.

- *Limited Exemption To Foreign Investment Advisers*. Many advisers based outside the United States that advise U.S. clients or U.S. domiciled funds will be required to register with the SEC. Section 202(a)(11) of the Advisers Act is amended to include the term "foreign private adviser." A foreign investment adviser will qualify for the foreign private adviser exemption from registration if it (i) has no

[4] The categories of investors include the following: (i) natural persons who at the time of their applicable investment are officers, directors or employees of the family office who (a) have invested with the family office before January 1, 2010 and (b) are accredited investors, as defined in Regulation D under the Securities Act of 1933, as amended, or as the SEC may prescribe by rule, the successors-in-interest thereto; (ii) any company owned exclusively and controlled by members of the family of the family office, or as the SEC may prescribe by rule; and (iii) any investment adviser registered under the Advisers Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice, represent in the aggregate, not more than five percent (5%) of the value of the total assets as to which the family office provides investment advice.

place of business in the United States; (ii) has, in total, less than 15 clients and investors in private funds; (iii) has, in the aggregate, less than $25 million AUM attributable to U.S. clients and investors in private funds (or such higher amount as the SEC may, by rule, deem appropriate); and (iv) does not (1) hold itself out generally to the public in the United States as an investment adviser or (2) act as an investment adviser to a registered investment company or a business development company. It is important to note that foreign advisers that qualify as foreign private advisers will now be subject to the full reporting regime of the Advisers Act; the Act does not provide such foreign advisers with the "*registration lite*" reporting scheme previously afforded non-U.S. investment advisers subject to regulation under the Advisers Act.

The Act also aggregates U.S. clients with U.S. investors in private funds for purposes of determining whether or not an adviser qualifies as a foreign private adviser. Questions remain as to whether or not the SEC will have jurisdiction over such non-US advisers that have no direct contacts with the United States. A similar look-through rule–the so-called SEC "hedge fund registration rule"–was ruled invalid by the D.C. Circuit Court case *Goldstein v. SEC*. The case held that a private fund, not the underlying investors in such fund, was the client of an investment adviser for purposes of counting clients and meeting the 15 client threshold under the prior private adviser exemption.

Registration Under The Connecticut Uniform Securities Act

Connecticut, like many other states has a *de-minimis* exemption from registration, which exempts from state registration any investment adviser that has no place of business in Connecticut and during the preceding 12 months has had no more than five clients who are residents of the State. Currently, any Connecticut investment adviser that has $30 million or more of AUM and fewer than 15 clients is excluded from the definition of "investment adviser" under an order previously issued by the Connecticut Banking Commissioner. Since the 15 client private adviser exemption has been removed from Section 203(b)(3) of the Advisers Act, the application of the order is unclear.

The Connecticut Banking Department is currently analyzing the Act and its impact on CUSA. We will continue to monitor the Department's progress and update this alert with any further developments.

Adjusting The Accredited Investor Standard And Qualified Client Standard; Definition of "Client"

- Accredited Investor Standard. **Effective July 21, 2010** and for the four year period following such date, the net worth standard for accredited investors who are natural persons will be $1,000,000 *excluding* the value of the primary residence of such person.[5] ***As such, private funds and any other issuers must amend their subscription agreements to reflect this revised definition for any subscriptions (including additional capital contributions from existing investors) accepted after July 21, 2010***. After the four year period the SEC is directed to review the accredited investor definition for individuals, including the net worth and income tests, and make adjustments to the definition as the SEC deems appropriate.

- Qualified Client Standard. Section 205(e) of the Advisers Act is amended to require **by July 21, 2011 and every five years thereafter**, the SEC to adjust the net asset threshold test for the effects of inflation in order to determine clients

[5] The SEC staff has confirmed in a recent SEC Compliance and Disclosure Interpretation release that any related indebtedness secured by the primary residence (up to fair market value) may also be excluded for purposes of the net worth test. Indebtedness secured by an investor's primary residence in excess of the value of the residence will be considered a liability and such excess will be deducted from the investor's net worth.

eligible to pay performance fees to registered investment advisers.

- *"Client" Defined*. For purposes of the antifraud provisions of Section 206 of the Advisers Act, the Act specifically prohibits the SEC from defining the term "client" as an investor in a private fund if the private fund has entered into an advisory agreement with the investment adviser. However, the SEC has authority to define the term "client" to include an investor in a private fund for purposes other than Section 206 (*e.g.,* the foreign private adviser definition described above).

Recordkeeping and Reporting

The Act authorizes the SEC to require registered investment advisers to maintain records and file reports with the SEC regarding private funds as necessary and appropriate for the protection of investors or for the assessment of systemic risk by the Financial Stability Oversight Council (the "**Council**"). In addition to existing Advisers Act requirements, the adviser must produce (for each private fund advised by the investment adviser) the following: (i) the amount of AUM and use of leverage (including off-balance sheet leverage); (ii) counterparty credit risk exposure; (iii) trading and investment positions; (iv) valuation policies and practices; (v) types of assets held; (vi) side arrangements or side letters; (vii) trading practices; and (viii) other information determined by the SEC, in consultation with the Council, to be necessary in the public interest, for the protection of investors or for the assessment of systemic risk.

New confidentiality protections have been included in the Act to complement the new reporting obligations.

Information Sharing; Confidentiality

- *Information Sharing*. The SEC must make available to the Council copies of all reports and records filed with or provided to the SEC by an investment adviser for the purpose of assessing systemic risk posed by a private fund.

- *Confidentiality*. The Act protects confidential and proprietary information of the investment adviser, including reports and records filed with or provided to the SEC. The SEC may be compelled to disclose confidential information of an investment adviser to (i) Congress; (ii) any federal department or agency or any self-regulatory organization ("**SRO**") (within the scope of its jurisdiction) upon a request for information; or (iii) comply with a court order. The Council or any federal department or agency or SRO that receives reports must keep them confidential and will be exempt from disclosure under the Freedom of Information Act. Client confidentiality is currently protected from SEC disclosure; however, the Act modifies Section 210(c) of the Advisers Act to permit the SEC to require any investment adviser to disclose the identity, investments or affairs of any client if the disclosure is necessary or appropriate for purposes of assessing potential systemic risk.

If you would like to discuss these issues in further detail, please contact Peter Bilfield at (203) 324-8151, or pbilfield@goodwin.com, John Lawrence at (860) 251-5139 or jlawrence@goodwin.com, or Jim Schulwolf at (860) 251-5949 or jschulwolf@goodwin.com. To view the final Dodd-Frank Act, please see http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.

Regulation of investment advisers and private investment funds constitutes only one (albeit a major one) of the many tentacles of the Dodd-Frank Act. Shipman & Goodwin will continue to inform its clients of the significant impacts of this ground-breaking legislation through a series of client alerts. In the meantime, if you have any questions on the following aspects of the Dodd-Frank Act, the attorneys identified below are ready to assist you:

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