Impact of Dodd-Frank on Investment Advisers

On June 22, 2011, the Securities and Exchange Commission ("SEC") adopted final rules under the Private Fund Investment Advisers Registration Act of 2010 (the "Act"), contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") relating to the registration of investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"). Specifically, the final rules (i) clarify the exemptions from investment adviser registration embodied in the Act (ii) establish a uniform method for calculating assets under management, (iii) reallocate regulatory responsibility for investment advisers between the SEC and states, and (iv) amend Form ADV to reflect new rules and regulations.

Advisers will not need to be in compliance with these new rules until March 30, 2012[1] but it is important to review how the Act alters the landscape of advisers subject to registration with the SEC. On the one hand, the Act broadens the scope of SEC regulation by eliminating what historically has been the primary exemption relied upon hedge funds, private equity funds and others, namely the "private adviser exemption."2 On the other hand, the Act effectively raises the threshold for SEC registration from $25 million in assets under management to $100 million, precluding smaller advisers from registering and requires others to withdraw their registration.

Registration Thresholds

Subject to certain exemptions (as outlined below), all investment advisers with assets under management of $100 million or more are required to register with the SEC. These provisions must be complied with on or after March 30, 2012; prior to that date, the exemptions available under the Advisers Act may still be relied upon (including the private adviser exemption). Subject to certain exceptions, an "investment adviser" generally means, any person who (i) for compensation, (ii) engages in the business of advising others (iii) about the value of securities, about the advisability of investing in, purchasing or selling securities, or about other investment advisers.

What Types of Investment Advisers Are Exempt from Registration with the SEC?

[1] The SEC noted that advisers filings an initial application for registration should complete an application before February 14, 2012 because it can take up to 45 days for the SEC to process an initial application for registration as an investment adviser.

[2] The private adviser exemption refers to Section 203(b)(3) of the Advisers Act, which exempts from registration an investment adviser that, during the preceding 12 months, had fewer than 15 clients and neither held itself out generally to the public as an investment adviser nor acted as an investment adviser to any SEC-registered investment company or business development company.

Certain Private Fund Advisers

Advisers acting solely as managers of one or more qualifying private funds and have less than $150 million in cumulative assets under management in the U.S. are exempt from SEC registration under the Act. Private funds those that rely on Sections 3(c)(1) or 3(c)(7) of the Advisors Act to avoid registration as an investment company. An adviser relying on this exemption must calculate and report annually to the SEC on Form ADV its regulatory assets under management to confirm that it remains eligible for the exemption.

Advisers to Venture Capital Funds

The Act provides an exemption from registration for advisers that advise solely venture capital funds. A "venture capital fund" is a private fund that:

- represents itself to investors and prospective investors as pursuing a venture capital strategy;
- immediately after the acquisition of any asset, holds no more than 20% of the fund's capital commitments in non-qualifying investments (other than short-term holdings) valued at cost or fair value, as consistently applied by the fund;
- does not borrow, issue debt obligations or otherwise incur leverage in excess of 15% of the fund's aggregate capital contributions and uncalled committed capital, and subject to an exception for guarantees of portfolio company indebtedness up to the value of the investment in the portfolio company, any such borrowing, debt or leverage is for a non-renewable term of no longer than 120 calendar days;
- does not offer redemption or similar liquidity rights to investors except under extraordinary circumstances; and
- is not registered under the Investment Company Act and has not elected to be treated as a business development company under the Investment Company Act.

The term "qualifying investment" generally is defined as (i) an equity security issued by a qualifying portfolio company that is directly acquired by the private fund from the company ("directly acquired equity"); (ii) an equity security issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company; and (iii) an equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and that is acquired by the fund in exchange for directly acquired equity. The term "qualifying portfolio company" is defined as any company that: (i) at the time of any investment, is not reporting or foreign-traded and does not control, is not controlled by or under common control with a reporting or foreign-traded company; (ii) does not borrow or issue debt obligations in connection with the investment by the private fund and distribute to the private fund the proceeds of any such borrowing or debt issuance in exchange for the private fund

investment; and (iii) is not itself a investment company, fund or commodity pool (i.e., is an operating company).

The 20% basket was not contained in the SEC's release proposing the rule, and is intended to provide greater investment flexibility for venture capital funds while maintaining the scope of the exemption. Under the rule, there is no restriction on the type of investment which may be held by a venture capital fund in its 20% basket. For example, the 20% basket may be used to make occasional debt investments, pursue cash management strategies that involve instruments other than permitted cash items, or purchase equity securities from other investors in a portfolio company.

The 20% basket is calculated as a percentage of a fund's total capital commitments. Since total capital commitments generally remain constant during the term of a venture capital fund, this approach is intended to provide venture capital fund advisers with a degree of predictability in managing venture capital funds in compliance with the 20% basket. In calculating whether a venture capital fund complies with the 20% basket, investments may be valued at either their cost or fair value provided the same method is used for all investments made by a venture capital fund throughout its term. Venture capital funds are required to calculate their compliance with the 20% basket whenever they acquire a non-qualifying investment (other than a permitted short-term holding).

The final rule contains a grandfathering provision that includes, in the definition of "venture capital fund," funds that (i) represented to investors and potential investors at the time they offered their securities that they pursued a venture capital strategy, (ii) sold securities to one or more unaffiliated investors prior to December 31, 2010 and (iii) do not sell any securities to, or accept any capital commitments from, any person after July 21, 2011. However, a fund that meets these conditions may continue to rely upon the grandfathering provision even if it draws down its capital commitments after July 21, 2011.

Mid-Sized Advisers

The Act raises the assets under management threshold for registration with the SEC from $25 million to $100 million. Specifically, so called "mid-size" advisers with assets under management of between $25 million and $100 million that are required to be registered in their home states and, if registered, would be subject to examination, are precluded from registering with the SEC. However, advisers that advise business development companies or SEC- registered investment companies, and advisers that would be required, under the Act, to register with 15 or more states, must continue to register with the SEC.

Under the final rules, a mid-sized adviser must register with the SEC if, under the laws of the state in which its principal office and place of business is located, the adviser relies on an exemption

from registration as an investment adviser or is excluded from the definition of investment adviser. Furthermore, a mid-sized adviser is also required to register with the SEC if the adviser is registered with a state, but not subject to examination by such state by virtue of such registration. New York and Minnesota advised the SEC that they do not conduct examinations of investment advisers. Therefore, unless an exemption from registration is available, such as the private fund adviser or venture capital fund exemptions, advisers with a principal office and place of business in New York or Minnesota must register with the SEC if they have $25 million or more in assets under management.

If a mid-sized adviser that is registered with the SEC on January 1, 2012, is no longer eligible for such registration, the adviser will have until June 28, 2012, to withdraw its registration with the SEC and register with the applicable state securities authorities.

Family Offices

Dodd-Frank amends the Advisers Act to exclude "family offices" from the definition of investment adviser. A family office is defined as any company that: (i) has no clients other than "family clients," (ii) is wholly owned by family clients and controlled, directly or indirectly, by "family members" and/or "family entities," and (iii) does not hold itself out to the public as an investment adviser. The rule also contains grandfathering provisions.

Non U.S. Private Advisers

The Act creates a new category of "foreign private adviser" exempt from registration provided such adviser: (i) has no place of business in the United States; (ii) has fewer than 15 clients and investors in the United States in private funds advised by the adviser; (iii) has less than $25 million of assets under management attributable to clients and investors in the United States in private funds advised by the adviser; and (iv) does not hold itself out generally to the public in the United States as an investment adviser and does not advise business development companies or SEC-registered investment companies.

For purposes of determining the number of clients and assets under management for this exemption, foreign advisers must count individual investors in private funds, and their commitments to such funds (and not the drawn-down amounts), toward the 15 client/investor and $25 million thresholds.

Calculating Assets under Management

The final rules establish a uniform methodology to be used by advisers to calculate their assets under management for purposes of determining whether they are required to register with the SEC. Under the final rules, advisers must calculate their "regulatory assets under management," which must include all securities portfolios for which an adviser provides continuous and regular

supervisory or management services. Regulatory assets under management must include: (i) proprietary assets, (ii) assets managed without compensation, and (iii) assets of non-U.S. clients. Regulatory assets under management must be determined on a gross basis, and accordingly, advisers are not permitted to subtract outstanding indebtedness or other accrued but unpaid liabilities in their calculations.

In addition, all advisers are generally required to use the current market values of securities, rather than cost, in their calculations of regulatory assets under management, provided that advisers may use the fair value of private fund assets where market value is unavailable. Under the final rules, an adviser to a private fund must include in its regulatory assets under management (i) the value of any private fund it manages regardless of the nature of the assets held by the private fund, and (ii) the amount of any uncalled capital commitments made to the fund. A sub-adviser to a private fund need only include in its regulatory assets under management the portion of the value of the securities portfolio for which it serves as sub-adviser. The method for calculating regulatory assets under management is set forth in detail in the amended instructions to Part 1A of Form ADV.

Reporting by Exempt Reporting Advisers

Advisers relying on the exemption for private fund or for venture capital fund advisers are subject to some, but not all, of the reporting requirements that apply to registered advisers. These exempt advisers as referred to as "exempt reporting advisers." The SEC, rather than developing a new form for reporting by exempt reporting advisers, has required that they file Part 1A of Form ADV in much the same manner as registered advisers. Exempt reporting advisers are required to complete some portions of Part 1A, including: (i) basic identifying information about the adviser and its owners/affiliates, including: (ii) the basis for its exemption from SEC registration, (iii) its form of organization, (iv) its other business activities, (v) its financial industry affiliations and private funds it manages, (vi) its control persons, and (vii) disciplinary history.

Other Important Implications of Dodd-Frank for Investment Advisers

Accredited Investor Standard Revised: The definition of "accredited investor" under Regulation D of the Securities Act of 1933 is revised to exclude the value of a person's primary residence for purposes of the $1 million minimum net worth standard. This provision became effective upon signing. The Act directs the SEC to consider adjusting the net worth standard every four years, presumably to reflect inflation. Advisers should consider whether their account opening or subscription documents, or offering materials, need to be amended to reflect this change.

"Bad Actors" May Not Use Reg. D: The Act also precludes persons sanctioned by regulators, convicted of a misdemeanor or felony involving securities, or of making false claims to the SEC from relying on the safe harbor provisions of Regulation D.

Short Sales Reported on 13F: The Act also mandates that Form 13F filers report information about short sales of securities they report on Form 13F. The information will be collected and published for the public record on a monthly basis.

Bank Sponsorship of Private Funds Limited: Under the "Volcker Rule," as adopted in Dodd-Frank, banking entities cannot acquire or retain ownership interests in or sponsor hedge funds or private equity funds unless this interest is less than 3% of the total ownership interests issued by the private fund at the end of its inaugural year, and the total banking entity exposure to all such funds does not exceed 3% of the bank's Tier 1 capital. In addition, a banking entity can sponsor a fund only if the fund is available only to the entity's banking customers, and meets other limitations.

Expanded Scope of Aiding and Abetting. The Act changes the landscape of liability for "aiding and abetting" violations of law by instituting a new "reckless" standard. Prior to the Act, aiding and abetting liability required a showing of "knowing and substantial assistance" to the primary violator. The Act also expands the scope of the Advisers Act by mandating that a person who aids or abets a violation by another person liable to the same extent as the primary violator.