The Impact of Title IV of the Dodd-Frank Act on Investment Advisers

Contributed by Kenneth Muller and Seth Chertok, Morrison & Foerster LLP

In July 2010, Congress agreed on a final version of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act). Title IV of the Act (Title IV), which generally will become effective on July 21, 2011, is primarily concerned with changes to investment adviser registration under the Investment Advisers Act of 1940 (Advisers Act), but also contains an array of additional issues that affect investment advisers. This article considers the impact of Title IV on investment advisers and provides a summary of the issues we feel are the most critical to understand.

Adviser Registration and Exemptions

Section 203(b)(1): The Intrastate Advisers Exemption

Under the Dodd-Frank Act, the intrastate advisers exemption in Section 203(b)(1) of the Advisers Act is retained, but investment advisers that advise any "private funds" may not rely upon it.[1] "Private funds" under the Dodd-Frank Act include an investment fund that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (Investment Company Act), but for the exemptions in Section 3(c)(1) or Section 3(c)(7) thereof.[2] Since these are the most common Investment Company Act exemptions used by private equity funds and hedge funds, investment advisers to most types of private equity funds and hedge funds will be considered to advise "private funds" and therefore will be unable to use the intrastate exemption in Section 203(b)(1).

Section 203(b)(3): The Fewer than 15 Clients Exemption

The revisions to Section 203(b)(3) of the Advisers Act will close the private funds exemption. Section 203(b)(3) is the most frequently relied upon Advisers Act exemption and exempts from registration investment advisers that advise fewer than 15 clients and meet certain other conditions. Revised Section 203(b)(3) will only provide an exemption with respect to "foreign private advisers."[3] The definition of "foreign private adviser" will require, among other things, that (1) the investment adviser have, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser; and (2) the investment adviser have aggregate assets under management attributable to clients in the United States and U.S. investors in private funds advised by the investment adviser of less than $25 million.

The term "client" has been construed with respect to advisers that advise pooled investment vehicles as encompassing such pooled investment vehicles, rather than the individual investors therein.[4] By totaling "investors" in "private funds" with the number of "clients," the Dodd-Frank Act will

© 2011 Morrison & Foerster LLP. Originally published by Bloomberg Finance L.P. in the Vol. 5, No. 4 edition of the Bloomberg Law Reports—Securities Law. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.

This document and any discussions set forth herein are for informational purposes only, and should not be construed as legal advice, which has to be addressed to particular facts and circumstances involved in any given situation. Review or use of the document and any discussions does not create an attorney-client relationship with the author or publisher. To the extent that this document may contain suggested provisions, they will require modification to suit a particular transaction, jurisdiction or situation. Please consult with an attorney with the appropriate level of experience if you have any questions. Any tax information contained in the document or discussions is not intended to be used, and cannot be used, for purposes of avoiding penalties imposed under the United States Internal Revenue Code. Any opinions expressed are those of the author. Bloomberg Finance L.P. and its affiliated entities do not take responsibility for the content in this document or discussions and do not make any representation or warranty as to their completeness or accuracy.

overrule *Goldstein v. SEC* in the context of Section 203(b)(3) of the Advisers Act.

Section 203(b)(6): The CFTC Exemption

The Dodd-Frank Act retains the existing exemption under Section 203(b)(6) of the Advisers Act (which it designates as Section 203(b)(6)(A)) but also adds an additional exemption under Section 203(b)(6)(B) for any investment adviser that is registered with the CFTC as a commodity trading advisor (CTA) and advises a "private fund," provided that if the business of the CTA should become predominately the provision of securities-related advice, then the CTA will be required to register with the SEC.[5] Section 203(b)(6)(B) expands the scope of investment adviser exemptions for certain registered CTAs that advise at least one "private fund." It should also be noted that if the exemption criteria in Section 203(b)(6)(B) are met, investment advisers to (1) registered investment companies, and (2) any company that has elected to be a "business development company," could obtain an exemption under Section 203(b)(6)(B), which was not previously the case.[6]

The SBIA Exemption

The Dodd-Frank Act adds a new registration exemption in Section 203(b)(7) of the Advisers Act that applies to investment advisers to certain types of small business investment companies.[7] This provision could make structuring funds as small business investment companies attractive for certain advisers desiring federal exemptions, especially when taking into consideration that such structuring could also potentially give some relief from the Volcker rule to the extent "banking entities" and "nonbank financial companies supervised by the Board of Governors" invest in a fund.[8]

The Venture Capital Exemption

The Dodd-Frank Act provides that "no investment adviser that acts as an investment adviser solely to 1 or more venture capital funds shall be subject to the registration requirements of this title with respect to the provision of investment advice relating to a venture capital fund."[9] In addition, the Act gives the SEC the authority to require advisers to maintain records and provide annual or other reporting to the SEC, as it determines is necessary or appropriate in the public interest or for the protection of investors.[10] The Dodd-Frank Act does not define the term "venture capital fund," but leaves that determination to future SEC rules.

The Private Fund Exemption

The Dodd-Frank Act adds Section 203(m) under the Advisers Act, which provides that the SEC will exempt from registration any investment adviser of "private funds" if such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150 million.[11] The Dodd-Frank Act provides that the SEC will require investment advisers who rely on this exemption to maintain records and provide the SEC with annual or other reports, as the SEC determines necessary or appropriate in the public interest or for the protection of investors.[12] The exact scope of recordkeeping and reporting will be subject to future SEC rulemaking.

Family Offices

The Dodd-Frank Act adds an exclusion from the definition of "investment adviser" in Section 202(a)(11) of the Advisers Act that will apply to "any family office, as defined by rule, regulation or order of the [SEC]."[13] For our previous discussion of this exclusion, *see* Bloomberg Law Reports®—Fund Management, *The SEC's Proposed Rule Regarding the Family Offices Exemption*, Contributed by Kenneth Muller and Seth Chertok, Morrison & Foerster LLP (Dec. 10, 2010).

Asset Threshold for Federal Registration of Investment Advisers

© 2011 Morrison & Foerster LLP. Originally published by Bloomberg Finance L.P. in the Vol. 5, No. 4 edition of the Bloomberg Law Reports—Securities Law. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.

The Dodd-Frank Act retains the $25 million floor for federal registration for private equity advisers subject to state regulation in the state in which they maintain their principal office and place of business (to the extent they are not covered "mid-sized investment advisers" within the meaning of Section 203A(a)(2)(B) of the Advisers Act). Covered mid-sized investment advisers are generally subject to a $100 million floor, unless they advise a registered investment company or a company that has elected to be a "business development company" or the investment adviser is required to register with 15 or more states, in which case the adviser is presumably subject to the $25 million floor. Section 203A(a)(2)(B) defines a covered mid-sized investment adviser for purposes of Section 203A(a)(2) as an investment adviser that (1) is required to be registered as an investment adviser with the securities commission (or any agency or office performing like functions) of the state in which it maintains its principal office and place of business and, if registered, would be subject to examination as an investment adviser by any such commissioner, agency, or office; and (2) has assets under management between (a) the amount specified under Section 203A(a)(1)(A) (currently $25 million) as such amount may have been adjusted by the SEC pursuant to that subparagraph, and (b) $100 million, or such higher amount as the SEC may, by rule, deem appropriate.[14]

For most, *but not all*, mid-sized investment advisers, the Dodd-Frank Act will raise the floor for federal registration to $100 million in assets under management. However, mid-sized investment advisers that are not required to register under state law or are not subject to state examinations, who advise registered investment companies or "business development companies," or who are required to register with 15 or more states, will continue to be subject to a lower floor, rather than the $100 million floor. Private equity mid-sized investment advisers that desire federal registration will have to structure their investment operations so that they would generally be required to register with 15 or more states, or so that they advise only business development companies.

The New Exemptions: Open Issues

Several of the new registration exemptions depend upon an adviser solely advising certain types of funds. Future no-action guidance will be required to determine whether an adviser that has affiliates that do not qualify for an exemption could rely on the applicable exemption. In addition, it is unclear whether advisers could simultaneously rely on two exemptions, each of which require that the adviser advise only one type of fund. For example, the SEC should consider whether an investment adviser that advised venture capital funds and private equity funds, with aggregate private equity assets under management under $150 million but aggregate private equity assets and venture capital assets under management above $150 million, should simultaneously be able to rely on the venture capital and private funds exemptions.

Consequences of Dodd-Frank Act Registration Provisions for Private Equity Funds

Reaffirmation of Goldstein

While the Dodd-Frank Act essentially reaffirms the *Goldstein* decision in the context of the antifraud provisions of the Advisers Act, it leaves open the possibility that the SEC could define "client" in another way for purposes other than Section 206(1) and Section 206(2) of the Advisers Act. The significance of affirming *Goldstein* in the context of the antifraud provisions of the Advisers Act is limited, since after *Goldstein* the SEC promulgated Advisers Act Rule 206(4)-8, which created an antifraud provision that applies to fraud committed against "investors." However, it is possible that the SEC would, in other contexts, define "client" as including investors for purposes such as the restrictions on incentive fees in Section 205(a)(1) of the Advisers Act and Rule 205-3 thereunder. The SEC may also define the term "client" to include

© 2011 Morrison & Foerster LLP. Originally published by Bloomberg Finance L.P. in the Vol. 5, No. 4 edition of the Bloomberg Law Reports—Securities Law. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.

investors for purposes of Section 206(3) of the Advisers Act and Rule 206(3)-2 thereunder.

Records and Reports of Private Funds

The Dodd-Frank Act imposes new recordkeeping and reporting requirements on registered investment advisers in new Section 204(b) to the Advisers Act.[15] The Dodd-Frank Act authorizes the SEC to require any registered investment adviser to maintain such records of, and file with the SEC such reports regarding, "private funds" advised by the investment adviser as are necessary or appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council (FSOC"), and to provide to the FSOC those reports and records and the information contained therein.[16]

The Dodd-Frank Act prescribes certain categories of records and reports that must be maintained by private funds advised by an investment adviser and that will be subject to inspection by the SEC. Most of these categories relate to the status of a fund's portfolio investments as well as to areas that are likely to involve conflicts of interests.

The Act also provides that the SEC may not be compelled to disclose any report or information contained therein required to be filed with the SEC under new Section 204(b), subject to the SEC's obligations to make disclosure to certain branches of the government. [17] Thus, reports made under this subsection would not be publicly available, whereas it would be possible for reports under the private funds or venture capital exemptions to be made publicly available. However, "proprietary information" of an investment adviser ascertained by the SEC from any filed report will be subject to Section 210(b) of the Advisers Act, which places a stronger confidentiality obligation on the SEC.

Further, the Dodd-Frank Act requires the SEC to conduct periodic inspections of all records of private funds maintained by a registered investment adviser and to conduct additional examinations as the SEC determines are consistent with the public interest and for the protection of investors, or for the assessment of systemic risk.[18]

Adjustments for Inflation to Investor Qualification Standards

Advisers Act Rule 205-3 contains an exception to the general prohibition on incentive fees, found in Section 205(a)(1), and applies where the performance fee or incentive fee arrangement is paid by "qualified clients."[19] Under the Dodd-Frank Act, the SEC is required, not later than one year after the date of the enactment thereof and every five years thereafter, to adjust for the effects of inflation on this standard. [20]Similarly, the Dodd-Frank Act allows the SEC to adjust for inflation any net worth standard for an "accredited investor" [21] so that the individual net worth of any natural person, or joint net worth with the spouse of that person, at the time of purchase, is more than $1 million (as such amount is adjusted periodically by rule of the SEC), excluding the value of the primary residence of such natural person.[22]

Comptroller General Studies on Private Funds

The Dodd-Frank Act requires the Comptroller General of the United States to conduct a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds.[23] The Act also requires the Comptroller General to conduct a study on the feasibility of forming a self-regulatory organization (SRO) to oversee private funds.[24] As a result, it is possible that further regulation of suitability standards for investing in private funds and an SRO regulating private funds could be on the horizon.

SEC Study and Report on Short Selling

Prior to the enactment of the Dodd-Frank Act, a number of regulatory measures had been taken to regulate short sales, including amendments to Regulation SHO. The Dodd-Frank Act directs the

© 2011 Morrison & Foerster LLP. Originally published by Bloomberg Finance L.P. in the Vol. 5, No. 4 edition of the Bloomberg Law Reports—Securities Law. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.

SEC's Division of Risk, Strategy, and Financial Innovation to conduct certain further studies regarding the regulation of short sales. One should expect that there likely will be more regulation of short sales that could impact private equity funds.

Other Implications of Dodd-Frank for Advisers

Disclosure under Section 210(c)

Prior to the enactment of the Dodd-Frank Act, Section 210(c) of the Advisers Act provided that the SEC could not require investment advisers to disclose the identity, investments, or affairs of any client, except in connection with proceedings or investigations. The Act amends Section 210(c) to provide that investment advisers may be required to disclose such information for purposes of assessment of potential systemic risk, reflecting the Senate Bill’s policy focus on systemic risk.[25]

Custody of Client Assets

Historically, the SEC used Rule 206(4)-2 under the Advisers Act to regulate a registered investment adviser’s custody of client funds and securities. Rule 206(4)-2 also includes certain requirements for safeguarding client funds and securities. The Dodd-Frank Act amends the Advisers Act to add new Section 223, which provides that registered investment advisers must take steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the SEC may, by rule, prescribe.[26]

Rule of Construction Relating to the Commodities Exchange Act

The Dodd-Frank Act adds a new provision that provides that nothing in the Advisers Act shall relieve any person of any obligation or duty, or affect the availability of any right or remedy available to the CFTC or any private party, arising under the Commodity Exchange Act governing commodity pools, commodity pool operators, or commodity trading advisors.[27]

Transition Period

Title IV of the Dodd-Frank Act becomes effective on July 21, 2011, one year after the date of the Act's enactment. However, an investment adviser may, at its discretion, register with the SEC under the Advisers Act at any time during that one-year period, subject to the rules of the SEC.[28] Not all investment advisers will have to register under the Advisers Act in the wake of the Dodd-Frank Act. However, to the extent an investment adviser must register under the Advisers Act, the adviser will become subject to the full scope thereof.

Kenneth W. Muller is a partner in the San Francisco office of Morrison & Foerster and currently serves as a co-chair of its Private Equity Fund Group and Private Equity Buyout Group. Mr. Muller represents private equity funds, venture capital funds, leveraged buyout funds, real estate funds, debt funds, and emerging growth companies in all aspects of their enterprises. He has represented some of the largest and well-known sponsors of private equity, venture capital, and real estate funds. Mr. Muller advises private equity clients on their business, economic, tax, securities, regulatory, and compliance issues. Mr. Muller frequently writes and lectures on private equity, tax, securities, and limited liability company issues.

Seth Chertok is a senior associate in the San Francisco office of Morrison & Foerster and is a member of the firm’s Private Equity Fund Group. Mr. Chertok’s practice focuses on private equity, M&A, private equity real estate, hedge funds, alternative investment funds, and non-profit organizations. Mr. Chertok has advised private equity clients on the general partner fund formation side and on the limited partner investor side. Mr. Chertok also has represented buyers and sellers in secondary transactions involving private equity funds. Mr. Chertok advises private equity clients on their

© 2011 Morrison & Foerster LLP. Originally published by Bloomberg Finance L.P. in the Vol. 5, No. 4 edition of the Bloomberg Law Reports—Securities Law. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.

business, economic, tax, securities, regulatory, and compliance issues.

The authors would like to thank Steve Frankenstein for his research assistance.

© 2011 Morrison & Foerster LLP

---

[1] Dodd-Frank Act, Section 403.

[2] The definition of an "investment company" is beyond the scope of this article but, subject to certain exceptions, generally includes, without limitation, most types of companies that (1) invest more than 40 percent of their total assets (excluding government securities and cash) in securities on an unconsolidated basis, or (2) hold themselves out as primarily engaged in the business of investing in securities. *See* Sections 3(a)(1)(A) and (C) of the Investment Company Act.

[3] Dodd-Frank Act, Section 403.

[4] *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

[5] Dodd-Frank Act, Section 403.

[6] Willkie, Farr & Gallagher Client Memorandum, *The Dodd-Frank Act Overhauls the Regulation of Private Fund Manager and Other Money Managers* (July 23, 2010).

[7] Dodd-Frank Act, Section 403.

[8] Dodd-Frank Act, Section 619.

[9] Dodd-Frank Act, Section 407.

[10] *Id*.

[11] Dodd-Frank Act, Section 408.

[12] *Id*.

[13] Dodd-Frank Act, Section 409.

[14] Dodd-Frank Act, Section 410.

[15] Senate Bill, Section 404.

[16] *Id*.

[17] *Id*.

[18] *Id*.

[19] In general, a "qualified client" is defined under Advisers Act Rule 205-3 as a natural person or entity that (1) immediately after entering into the advisory contract has at least $750,000 under the management of the investment adviser, or (2) the adviser reasonably believes, immediately prior to entering into the advisory contract, has a net worth (together with assets held jointly with a spouse) of more than $1.5 million at the time the contract is entered into.

[20] Dodd-Frank Act, Section 418.

[21] In general, an "accredited investor" is defined in Rule 501 under the Securities Act of 1933 as (1) any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1 million; (2) any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; or (3) any entity not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5 million.

[22] Dodd-Frank Act, Section 413.

[23] Dodd-Frank Act, Section 415.

[24] Dodd-Frank Act, Section 416.

[25] Dodd-Frank Act, Section 405.

[26] Dodd-Frank Act, Section 411.

[27] Dodd-Frank Act, Section 414.

[28] Dodd-Frank Act, Section 419.

© 2011 Morrison & Foerster LLP. Originally published by Bloomberg Finance L.P. in the Vol. 5, No. 4 edition of the Bloomberg Law Reports—Securities Law. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.