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GlobalNote®

DODD-FRANK ACT CHANGES REGULATORY REGIME FOR INVESTMENT ADVISERS

To: Clients and Friends of Tannenbaum Helpern Syracuse & Hirschtritt LLP¹

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I. Introduction

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Act”) into law. The Act provides for major changes to the financial services industry, significant amendments to the Investment Advisers Act of 1940, as amended (the “Advisers Act”), and a number of new requirements found in Title IV of the Act (“Title IV”) entitled the “Private Fund Investment Advisers Registration Act of 2010” that will impact investment advisers of private investment funds and separately managed accounts. Title IV sets forth new parameters for federal and state registration of investment advisers, includes additional obligations relating to advisers to “private funds” and adjusts certain net worth requirements that private fund investors need to satisfy. While there are other provisions of the Act which will affect some investment advisers, including the so-called “Volcker Rule” and the provisions relating to over-the-counter (“OTC”) derivatives, this GlobalNote focuses on Title IV.

Except as otherwise provided herein, the provisions of Title IV will become effective on July 21, 2011, one year after the date of enactment (the “Title IV Effective Date”). Unless otherwise noted, the Securities and Exchange Commission (the “SEC” or the “Commission”) rulemaking requirements below have no required date for completion.

II. Registration of Private Fund Advisers

Currently and until the Title IV Effective Date, investment advisers who manage \$25 million or more assets under management, or are otherwise eligible to register (e.g., acting as an investment adviser to a registered investment company), are permitted to register with the SEC and investment advisers who manage \$30 million or more assets under management are required to register with the SEC absent an exemption from registration, such as § 203(b)(3) of the Advisers Act. As discussed below, Title IV

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contains provisions that significantly change the registration requirements for investment advisers and the exemptions therefrom.

a. Changes to Exemptions from Registration under the Advisers Act for Private Fund Advisers²

i. Elimination of Private Adviser Exemption

Title IV eliminates the private adviser exemption currently found in §203(b)(3) of the Advisers Act (known as the “private adviser exemption”). The private adviser exemption provides that an adviser who (1) had fewer than fifteen (15) clients (where each fund was counted as one client) during the preceding twelve (12) months, (2) did not hold himself out generally to the public as an investment adviser and, (3) did not act as an adviser to a registered investment company (an “RIC”) or a business development company (a “BDC”), was exempt from registration as an investment adviser under the Advisers Act. Prior to July 21, 2010 (the “Date of Enactment”), many investment advisers relied on the private adviser exemption. The elimination of this exemption is one of the most notable amendments to the registration rules of the Advisers Act and will require many previously unregistered investment advisers who meet the jurisdictional thresholds described herein to register as investment advisers with the SEC, unless an exception applies.

ii. Limitation on Intrastate Exemption

The Act narrows the “intrastate exemption” found in §203(b)(1) of the Advisers Act, which provides an exemption from SEC registration for certain intrastate advisers. As revised, this exemption will no longer be available to investment advisers to private funds after the Title IV Effective Date.

iii. Change to CFTC-Registered Exemption

The Act preserves §203(b)(6) of the Advisers Act, which provides an exemption from registration to commodity trading advisers (“CTAs”) registered with the U.S. Commodities Futures Trading Commission (the “CFTC”) “whose business does not consist primarily of acting” as investment advisers as defined in §202(a)(11) and that do not serve as investment advisers to a RIC or a BDC. However, Title IV also expands the exemption for registered CTAs who manage a private fund as long as, after the Date of Enactment, the business of the adviser does not become “*predominantly* the provision of securities-related advice.” Of note, the term “predominantly” is not defined in the Act.

b. New Exemptions from Registration under the Advisers Act for Certain Private Fund Advisers

i. Addition of Exemption for Foreign Private Advisers

Title IV amends §203(b)(3) of the Advisers Act to add an exemption for “foreign private advisers.” As defined in §202(a)(30), a “foreign private adviser” is an adviser who (A) has no place of business in the U.S., (B) has, in total fewer than 15 clients *and investors* in the U.S. in private funds advised by the investment adviser, (C) has aggregate assets under management attributable to clients in the U.S. and investors in the U.S. in private funds advised by the investment adviser of less than \$25 million (or such higher amount as the SEC may determine), and (D) neither (i) holds itself generally to the U.S. public as an investment adviser, nor (ii) acts as (I) an investment adviser to any RIC or (II) a

² Title IV adds a definition of “private fund” in Section 202(a)(29) of the Advisers Act. The term “private fund” is defined to mean an issuer that would be an investment company, as defined in §3 of the Investment Company Act of 1940, as amended (the “Company Act”), but for §3(c)(1) (i.e., privately-offered funds with fewer than 100 investors) or §3(c)(7) (i.e., privately-offered funds where all investors are qualified purchasers) of the Company Act.

company that has elected to be a BDC and has not withdrawn its election. While the Act does not directly address the compliance “lite” regime that currently applies to many non-U.S. advisers, given prior SEC staff guidance and no-action letters it seems likely that even if non-U.S. advisers to offshore funds are required register with the SEC, the burden of registration and compliance may be lighter than the burden applicable to either U.S.-based advisers with offshore funds or to non-U.S. advisers to U.S.-based funds.

ii. Addition of Exemption for SBIC Advisers

Title IV adds §203(b)(7) of the Advisers Act to provide an exemption for an investment adviser who is not a BDC and who solely advises (A) small business investment companies that are licensees under the Small Business Act of 1958, (B) entities that have received a notice to proceed to qualify as a small business investment company and (C) applicants that are affiliated with any entity described in subparagraph (A) who have a pending application to be licensed under the Small Business Investment Act.

iii. Addition of Exemption for Venture Capital Fund Advisers

Section 203(l) of the Advisers Act is added to provide an exemption from registration for investment advisers that act as investment advisers solely to one or more “venture capital funds.” The SEC is required to define the term “venture capital fund” within one year of the Date of Enactment. The scope of this exemption will rely largely upon the SEC’s definition of “venture capital fund.” Investment advisers exempt pursuant to §203(l) will be required to maintain such records and provide such annual or other reports to the SEC as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

iv. Addition of Exemption for Certain Private Fund Advisers

Title IV adds §203(m) of the Advisers Act which directs the SEC to promulgate a rule providing an exemption from registration for any investment adviser that (i) acts solely as an adviser to private funds and (ii) has assets under management in the U.S. of less than \$150 million. Investment advisers exempted by this Section will be required to maintain such records and provide such annual or other reports to the SEC as the SEC determines necessary or appropriate in the public interest or for the protection of investors. The full scope and breadth of this exemption cannot be determined until the SEC has issued the applicable rules. This exemption will not be available to investment advisers that have any clients other than private funds (e.g., managed accounts).

v. Addition of Exemption/Alternative Registration for Mid-Size Private Fund Advisers

In prescribing regulation to carry out the registration requirements of §203 of the Advisers Act with respect to advisers to mid-sized private funds, the Act instructs the SEC to take into account the size, governance and investment strategy of such funds to determine whether they pose systemic risk and to provide registration and examination procedures which reflect the level of systemic risk posed by such funds.

c. Other Changes to Registration Under the Advisers Act

i. Change in State/Federal Registration Responsibilities

As mentioned above, prior to the Act, investment advisers not otherwise exempt from registration were generally prohibited from registering with the SEC if they had less than \$25 million of assets under management. Title IV in effect raises the minimum threshold for registration with the SEC for state-

regulated investment advisers to \$100 million of assets under management. The Act creates a new “mid-sized investment adviser” category in §203A(a)(1) whereby an adviser with assets under management between \$25 million and \$100 million (or such higher amount as the SEC determines) may only register with the SEC (and not a state) if such adviser (1) would not be subject to state registration and examination in the state in which it maintains its principal office and place of business, or (2) otherwise would be required to register with 15 or more states. Absent an exemption, advisers with \$100 million or more assets under management will effectively be required to register with the SEC, and those with less assets under management will in large part not be permitted to register with the SEC. Additionally, many advisers with assets under management between \$25 million and \$100 million that are currently registered with the SEC will have to withdraw their registration and register in their home states (and possibly other states in which they have clients). Of note, the SEC may by rule increase the \$25 million and \$100 million thresholds.

ii. Addition of Family Office Exclusion

New §202(a)(11)(G) directs the SEC to exclude “family offices” from the definition of “investment adviser” under the Advisers Act. The requirements of the “family office” exclusion must be consistent with prior exemptive relief and must recognize the range of organizational, management and employment structures and arrangement employed by family offices. The SEC rules must also contain a grandfather provision that includes in the definition of “family office” any person or entity that was not registered or required to be registered as an investment adviser under the Advisers Act on January 1, 2010 solely because the person provided investment advice and was engaged before January 1, 2010 in providing investment advice to certain natural persons and entities associated with a family office, including certain registered investment advisers that identified investment opportunities for the family office and invested in those opportunities on substantially the same terms as the family office. A grandfathered entity will however be deemed to be an “investment adviser” for purposes of Advisers Act Sections 206(1), (2) and (4), the broad anti-fraud provisions of the Advisers Act.

III. Private Fund Systemic Risk Data Collection

Title IV may result in certain recordkeeping and reporting requirements being imposed on registered investment advisers that advise private funds. These new requirements supplement those previously required under the Advisers Act. Certain exempt advisers may also be subject to reporting and recordkeeping requirements.

a. **General Recordkeeping and Reporting Requirement and SEC Examinations**

The Act adds §204(b) to the Advisers Act which provides that the SEC may require any registered investment adviser to maintain records and file reports with the SEC (and provide or make available those reports or records or the information contained therein to the Financial Stability Oversight Council (the “Council”)) regarding the private funds advised by the investment adviser as necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk by the Council. The records and reports of any private fund advised by an investment adviser shall be deemed to be the records and reports of the investment adviser. These records will be subject to periodic SEC examination as well as additional examinations as the SEC may deem necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

b. **Required Information**

The records and reports required to be maintained by an adviser and subject to inspection by the SEC include, for each private fund advised by the adviser, (i) the amount of assets under management and use of leverage, including off-balance sheet leverage, (ii) counterparty credit risk exposure, (iii) trading

and investment positions, (iv) valuation policies and practices of the fund, (v) types of assets held, (vi) side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors, (vii) trading practices, and (viii) any other information the SEC (in consultation with the Council) determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

c. SEC/CFTC Joint Registrations

Title IV requires the SEC and the CFTC to jointly promulgate rules with regard to the recordkeeping and reporting of private funds within twelve months of the Date of Enactment for investment advisers registered under both the Advisers Act and the Commodity Exchange Act, as amended (the “CEA”).

d. Information Sharing

The SEC will make available all reports, documents, records and information filed pursuant to the above private fund reporting requirements (“Private Fund Reporting Requirements”) (i) the Council considers necessary for the purpose of assessing the systemic risk posed by a private fund, (ii) the SEC considers necessary to comply with any request for information from any other Federal department or agency or any self-regulatory organization requesting a report or information for purposes within the scope of its jurisdiction, and (iii) the SEC considers necessary to comply with any order of U.S. court in an action brought by the U.S. or the SEC. The SEC shall report annually to Congress on how the SEC has used the data collected pursuant to the Private Fund Reporting Requirements to monitor the markets for the protection of investors and the integrity of the markets.

e. Confidentiality

The SEC, Council and any department, agency or self-regulatory organization that receives reports or information from the SEC pursuant to the Private Fund Reporting Requirements cannot be compelled to disclose any report or information (except as provided above) and are exempt from FOIA requests with respect to such reports or information. Any proprietary information of an investment adviser ascertained by the SEC shall be subject to the same limitations on public disclosure as any facts ascertained during an examination (as provided in §210(b) of the Advisers Act). Proprietary information includes: sensitive, non-public information regarding the adviser’s investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property, and any additional information that the SEC determines to be proprietary. The SEC will be allowed to compel an investment adviser to disclose the identity, investments, or affairs of its clients for the purposes of assessment of potential systemic risk.

IV. Miscellaneous

a. Clarification for Rulemaking Authority

Title IV clarifies that the SEC has the rulemaking authority to define technical, trade or other terms used in the Advisers Act. The Act also prohibits the SEC from defining the term “client” to include an investor in a private fund for purposes of §206(1) and (2) (the anti-fraud provisions), if such private fund has entered into an advisory contract with the investment adviser.

b. Custody of Client Assets

The Act adds §233 to the Advisers Act which provides that the SEC shall prescribe rules requiring registered investment advisers to safeguard client assets over which the adviser has custody, including verification of such assets by an independent public accountant. In addition, the U.S.

Comptroller General will conduct a study of the compliance costs associated with current SEC rules (Rule 204-2 books and records) and Rule 206(4)-2 (custody rule)) regarding custody and the additional costs if subsection Rule 206-4(b)(6) relating to operational independence were eliminated. The report shall be submitted to relevant House and Senate committees no later than 3 years after the Date of Enactment.

c. Effect on CEA

The Act also adds §234 to the Advisers Act to clarify that the Advisers Act does not 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 CEA.

V. Accredited Investor Standard

The Act modifies the definition of “accredited investor” in Regulation D under the Securities Act. Upon the Date of Enactment, the \$1 million net worth standard for natural persons must exclude the value of such person’s primary residence. The related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the fair market value of the home is considered a liability and is to be deducted from the investor’s net worth. A current individual investor in a private fund must meet the revised standard only when making an additional investment in the fund.

After the Title IV Effective Date, the SEC is authorized to review the accredited investor standards as they related to natural persons and to promulgate rules adjusting the provisions of the definition, provided that the SEC may not adjust or modify the net worth (\$1 million) threshold. Not earlier than four years after the Date of Enactment, and every four years thereafter, the SEC is required to review the entirety of the definition of “accredited investor” as applied to natural persons and the SEC is authorized to modify such definition as appropriate for the protection of investors, in the public interest and in light of the economy.

The Act also directs the SEC to adopt, prior to the Title IV Effective Date, rules to disqualify certain persons from relying on Rule 506 of Regulation D under the Securities Act. These rules would match the disqualifications provisions of Regulation A and provide additional bases for disqualifications including state administrative orders.

VI. Qualified Client Standard under Advisers Act Performance Fee Rule

Title IV directs the SEC to revise the “qualified client” standard of Rule 205-3 under the Advisers Act (governing the payment of performance fees to registered investment advisers) within one year after the Date of Enactment and every five years thereafter, to adjust for inflation.

VII. The Volcker Rule

Investment advisers that are affiliates of banks and bank holding companies will also be affected by the provisions found in Title VI of the Act referred to as the “Volcker Rule”. The Volcker Rule provisions affect “banking entities,” including insured depository institutions (i.e., banks), companies that control banks, bank holding companies and the affiliates of such entities, including private fund managers and broker-dealer subsidiaries and certain nonbank financial companies. Unless an exception applies, the Volcker Rule prohibits banking entities from engaging in proprietary trading and from acquiring, retaining an ownership interest in, or sponsoring a hedge fund or private equity fund. The Act provides for exceptions to these broad prohibitions. Among the most important exceptions for investment advisers are those for a banking entity sponsoring a hedge fund or private equity fund for its customers and for a

non-U.S. banking entity operating outside the United States. For the first exemption to apply, a banking entity may organize and offer a hedge fund or private equity fund if it abides by certain conditions including, but not limited to, ensuring that its investment does not exceed three percent of the total ownership interests in the fund and its aggregate interest in all hedge funds and private equity funds does not exceed three percent of its Tier 1 capital (generally cash, government securities or other highly liquid assets) or is immaterial (as defined by federal regulators) to the banking entity. A non-U.S. banking entity will have the ability to sponsor a hedge fund or private equity fund so long as no ownership interest in the fund is offered for sale or sold to a resident of the U.S. and the banking entity is not directly or indirectly controlled by a banking entity that is organized in the U.S. The Federal Reserve, other banking regulators, the SEC and the CFTC are directed to issue rules to implement each of these provisions, and the scope and timing of the provisions will depend on the approach taken by these regulators.

VIII. Regulation of OTC Derivatives

The Act also puts into place significant new regulation of OTC derivatives which could require certain entities that are counterparties to swaps (very broadly defined by the Act to include more than those instruments traditionally viewed as swaps) to register with the CFTC or the SEC. The provisions also subject these entities to clearing, margin and trading requirements when engaging in certain OTC transactions. Swaps subject to the clearing requirements will be required to be traded on a board of trade, on a securities exchange, or through a swap execution facility.

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If you have any questions or wish to discuss issues or concerns relating to Title IV, or any other item mentioned herein, please do not hesitate to contact us.