ADVISERS ACT REGISTRATION AND REGULATION OF PRIVATE FUND MANAGERS AND NON-U.S. INSTITUTIONS AFTER THE DODD-FRANK ACT

July 21, 2010

To Our Clients and Friends:

Today, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Under the Dodd-Frank Act, many private fund sponsors and other financial institutions (including certain non-U.S. advisers and financial institutions) that relied on the "fewer than 15 clients" exemption under the Investment Advisers Act of 1940 ("Advisers Act") will be required to register with the Securities and Exchange Commission ("SEC") by July 21, 2011 (the "Effective Date").

This memorandum discusses the Dodd-Frank Act's changes to the exemptions from registration under the Advisers Act, the impact of registration on private fund sponsors (including the new private fund recordkeeping and reporting requirements) and certain other provisions that may affect fundraising by private fund sponsors.

The Dodd-Frank Act's reach is wide-ranging. We recently published a more detailed summary of the Dodd-Frank Act, including the so-called "Volcker Rule" and potential systemic risk regulation.[1]

The SEC is charged with implementing certain aspects of the Dodd-Frank Act through required rulemaking processes. While this is likely to take some time, most U.S. and non-U.S. private fund sponsors, with certain exceptions, that are not currently registered need to begin their preparation for registration under the Advisers Act as soon as possible. In particular, these advisers will have to develop compliance policies and procedures to assure compliance with the Advisers Act.

THE END OF AN EXEMPTION: REGISTRATION OF PRIVATE FUND ADVISERS

Many private fund managers currently are exempt from Advisers Act registration under Section 203(b)(3), which provides an exemption from registration for an investment adviser that has fewer than 15 clients during the preceding 12 months and does not hold itself out to

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1 *Dodd-Frank Wall Street Reform and Consumer Protection Act: Summary of Key Provisions, available at http://www.debevoise.com/doddfrankact/.*

the public as an investment adviser. This exemption will be eliminated on the Effective Date.

After the Effective Date, with the limited exceptions noted below, investment advisers to private funds (including private equity funds and hedge funds) will be required to register with the SEC. "Private fund" is defined as an investment vehicle relying on one of the so-called private fund exemptions under the Investment Company Act of 1940 (the "Investment Company Act"): Section 3(c)(1) (privately-offered funds with fewer than 100 investors) or Section 3(c)(7) (privately-offered funds for which all of the investors are qualified purchasers). The definition of "private fund", therefore, covers hedge funds and private equity funds, including venture capital funds. It should be noted that certain financing vehicles (such as certain CDOs and corporate financing vehicles), and other entities that are not traditionally viewed as private funds, often rely on these exemptions and are considered "private funds" under the Dodd-Frank Act.

The Dodd-Frank Act also adjusts the applicability of other exemptions under the Advisers Act with respect to advisers to private funds. For example, an adviser to a private fund will not be able to rely on the "intrastate" adviser exemption. In addition, the Dodd-Frank Act limits the current exemption for an investment adviser registered with the Commodity Futures Trading Commission whose business does not consist primarily of acting as an investment adviser; such an adviser will not able to rely on the exemption if its business becomes predominantly the provision of securities-related advice.

NEW EXEMPTIONS FOR CERTAIN PRIVATE FUND ADVISERS

The Dodd-Frank Act provides new exemptions from Advisers Act registration, which may allow certain U.S. and non-U.S. advisers to private funds to continue to avoid registration. However, these private fund managers and advisers, for the most part, will not be entirely free from SEC oversight.

- **Advisers to Venture Capital Funds.** The new venture capital fund adviser exemption will be available to an investment adviser that acts as an investment adviser solely to venture capital funds. The SEC must adopt a rule defining the term "venture capital fund" by the Effective Date. The Dodd-Frank Act authorizes the SEC to subject these advisers to recordkeeping and reporting requirements.
- **Small Advisers to Private Funds.** The Dodd-Frank Act requires the SEC to promulgate rules providing an exemption for certain small advisers to private funds – that is, an investment adviser that (i) acts as investment adviser solely to private funds and (ii) has less than $150 million in "assets under management in the United States." As in the case of exempt venture capital fund advisers, these advisers may also be subject

to recordkeeping and reporting requirements. The required SEC rulemaking will likely clarify whether the phrase "assets under management in the United States" is intended to address the location of the investment adviser, the location of the investors in the private funds or the location of the portfolio investments of the private funds. The Dodd-Frank Act does not impose a deadline for the SEC to adopt rules relating to this exemption.

- **Advisers to Small Business Investment Companies.** A new exemption will be available to an adviser that provides advice solely to small business investment companies that are licensees (or certain applicants for licenses) under the Small Business Investment Act of 1958. These advisers would *not* be subject to additional recordkeeping and reporting requirements.
- **Family Offices.** The Dodd-Frank Act creates a new exclusion from the definition of "investment adviser" for "family offices." Family offices typically provide investment management and other services to members of a single family (as well as to certain employees of the family office). Subject to certain grandfathering provisions, the SEC is required to adopt a definition of "family office" that is consistent with the orders that it has previously issued to certain family offices exempting them from Advisers Act registration.

"FOREIGN" (NON-U.S.) PRIVATE ADVISERS

The Dodd-Frank Act also provides a new foreign private adviser exemption for an investment adviser that:

- has no place of business in the United States;
- has, in total, fewer than 15 clients in the United States and investors in the United States in private funds (including non-U.S. funds) that it advises; and
- has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds that it advises of less than $25 million (or such higher amount as the SEC determines).

The exemption is not available to an investment adviser who (i) holds itself out generally to the public in the United States as an investment adviser or (ii) acts as an investment adviser to an investment company registered under the Investment Company Act.

Although styled as an "exemption," this new provision could have a substantial impact on investment advisers based outside of the United States because of the new assets under

management requirement. Under the Dodd-Frank Act, a non-U.S. institution will not be able to rely on the new foreign private adviser exemption if it manages $25 million or more of U.S. client assets.

Accordingly, a non-U.S. investment adviser who sponsors a private fund formed outside the United States may be required to register under the Advisers Act if it raises $25 million or more from investors in the United States.

In addition to the foreign private adviser exemption, non-U.S. advisers may be eligible for any of the exemptions from registration described above. For example, certain non-U.S. advisers who provide advice solely to private funds may be able to qualify under the "small adviser to private funds" exemption, but its applicability will depend on how the SEC interprets the phrase "assets under management in the United States." If the phrase is interpreted to mean the location of the clients and investors, then the non-U.S. adviser in the example in the prior paragraph may be allowed to raise up to $150 million from investors in the United States for its non-U.S. private fund without being required to register under the Advisers Act. Similarly, depending on the SEC's definition of "venture capital fund," a non-U.S. adviser may be able to rely on the venture capital fund adviser exemption.

WHAT AWAITS A NEWLY REGISTERED INVESTMENT ADVISER?

The Advisers Act imposes significant substantive requirements on a registered investment adviser and the conduct of its business. Violations of the Advisers Act may result in the imposition of civil or administrative sanctions by the SEC, as well as substantial monetary penalties and criminal liability.

Among the more important requirements are the following:

- **Coordinated Compliance Program.** Registered investment advisers are required to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons. The adviser must also designate a chief compliance officer to administer its compliance policies and procedures. *Identifying a knowledgeable chief compliance officer should be a major priority as an adviser prepares for registration.*

- **Books and Records; SEC Inspections.** The Advisers Act imposes extensive books and records requirements. During an SEC inspection, an adviser's books and records are usually the subject of careful review. In the case of an adviser to a private fund, the adviser's books and records include the books and records of the fund. Under the Dodd-Frank Act, the SEC is required to promulgate rules requiring recordkeeping and reporting by investment advisers relating to any private funds to which they provide

investment advice. These requirement are designed to allow the SEC to collect information concerning, among other things, the use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies and practices, and side letters. The Dodd-Frank Act also allows the SEC to require the disclosure of the identities of an adviser's clients and related client information for the purpose of systemic risk assessment. The Dodd-Frank Act contemplates that this information will be shared with the Financial Stability Oversight Council for the purpose of assessing systemic risk and with other Federal regulators and self-regulatory organizations upon request, subject to certain conditions to protect confidentiality.

The SEC actively monitors compliance with the Advisers Act through its inspection program and conducts both routine and "for cause" inspections, each of which generally involves an SEC visit to an adviser's offices, as well as periodic "sweep" exams which typically involve document requests relating to a specific issue or practice. SEC inspections can last for several weeks, or even months. The Dodd-Frank Act also includes provisions that are likely to increase the number of examinations and change the structure of the examination process.

- **Performance-Based Fees; Management Agreements.** Investment advisory contracts with a registered adviser generally may not provide for compensation based on a share of capital appreciation (*e.g.*, "carried interest"), unless the fee is charged to, among other types of clients, (i) private funds consisting only of "qualified purchasers" (*i.e.,* "Section 3(c)(7) funds"), (ii) "qualified clients" who have $750,000 under management with the firm or have a net worth of $1.5 million or (iii) clients that are non-U.S. residents. The financial criteria in clause (ii) above may increase, as the Dodd-Frank Act requires that they be adjusted to give effect to inflation. Investment management and advisory agreements with clients must contain a provision requiring the client's consent to an "assignment" of the agreement.

- **Sales Materials.** Generally, the Advisers Act prohibits registered advisers from distributing any advertisement or other marketing material (such as a flip book) that, among other things, contains untrue statements of material fact or that is otherwise false or misleading. For example, Rule 206(4)-1 prohibits the use of testimonials in an adviser's marketing materials and contains conditions for disclosing prior recommendations by the investment adviser. In addition, the SEC staff has issued a number of "no-action" letters setting forth its views on the manner in which a track record may be presented. A firm should determine the extent to which these positions could apply to the firm's marketing materials. These marketing restrictions have been

the subject of numerous enforcement actions by the SEC, particularly in connection with marketing materials containing misleading information about the adviser's track record.

- **Use of Solicitors; Pay-to-Play Prohibitions.** Rule 206(4)-3 under the Advisers Act requires that the adviser enter into a written agreement with any person who solicits clients on behalf of the adviser and imposes on the adviser obligations to oversee the activities of the solicitor and arrange for the solicitor to provide certain disclosures to clients. The recently adopted pay-to-play rule (Rule 206(4)-5) places certain restrictions on the use of solicitors and placement agents in connection with the solicitation of state and local government business. We recently published a description of the new rule, which applies to registered investment advisers as well as advisers that are currently exempt from registration because they have fewer than 15 clients.[2]
- **Custody.** The protection of client assets from theft and embezzlement is an SEC priority. The Advisers Act custody rule requires, among other things, that client cash and assets (other than certain types of uncertificated securities) be maintained with a qualified custodian (*e.g.*, a bank or broker-dealer). The rule imposes other safeguards and controls which can be quite burdensome. In the case of a private fund adviser, many of these burdens can be avoided if the fund undergoes an annual audit by an independent accountant and the audited fund financial statements are distributed to investors within 120 days of the end of the fund's fiscal year (180 days in the case of a fund of funds). We recently published a description of amendments to the Advisers Act custody rule.[3]
- **Code of Ethics and Personal Securities Trading; Misuse of Nonpublic Information.** A registered investment adviser must adopt a code of ethics containing standards of conduct applicable to the firm and its employees. The code of ethics must require certain employees of the adviser to periodically report their personal securities transactions and holdings to the firm and to pre-clear certain types of personal securities transactions. In addition, a registered investment adviser must establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the investment adviser and its employees.

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[2] *Client Update: SEC Adopts New Pay-to-Play Rule, available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=8200106a-2f07-49b1-a3e6-99f1b0470e06.*

[3] *Client Update: How the SEC's New Custody Requirements Change the Ground Rules for Registered Investment Advisers, available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=d9666c13-358c-4e86-b1b2-11b1177353ff.*

- **Proxy Voting.** A registered investment adviser must have written proxy voting policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of clients.

- **Business Continuity Plans.** While not required by any rule, the SEC expects a registered investment adviser to develop a business continuity plan identifying procedures relating to an emergency or significant business disruption.

Non-U.S. institutions unable to satisfy the foreign private adviser exemption may take some comfort in the fact that, under traditional SEC staff positions, certain of the burdens of Advisers Act registration are not applicable to registered investment advisers that have their principal place of business outside of the United States in connection with their dealings with non-U.S. clients.

CHANGES TO REGULATION D PRIVATE OFFERING EXEMPTION

Most offerings of private fund interests in the United States rely on the exemption from registration under the Securities Act of 1933 provided in Regulation D, which, among other conditions, requires that purchasers of the offered securities be limited to "accredited investors" and a limited number of sophisticated investors. Currently, a prospective investor who is a natural person may qualify as an "accredited investor" if the investor has a net worth of greater than $1 million (*including* his or her principal residence) or meets certain annual income requirements. The Dodd-Frank Act changes the definition of "accredited investor" so that the net worth standard with respect to natural persons is calculated without the inclusion of the investor's principal residence. *This change appears to take effect immediately.* The Dodd-Frank Act also requires the SEC to promulgate rules expanding the list of disciplinary proceedings that may disqualify an issuer from relying on Regulation D.

CONCLUSION

While important new requirements under the Dodd-Frank Act are still to be determined by SEC rulemaking, currently unregistered investment advisers (especially advisers to private funds and non-U.S. institutions relying on the fewer than 15 clients exemption) should begin preparations for registration under the Advisers Act as soon as possible.

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