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DODD-FRANK BILL MOVES TOWARD PASSAGE: HIGHLIGHTS OF THE INVESTMENT ADVISER REGISTRATION REQUIREMENTS, ACCREDITED INVESTOR STANDARD AND THE VOLCKER RULE

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On June 30, 2010, the House of Representatives approved a comprehensive financial reform package known as the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. Passage of the Dodd-Frank bill in the House was the first step in approving the reform package that emerged from a joint congressional conference committee that had been reconciling separate financial industry regulatory reform proposals passed by the House in December 2009 and the Senate in May of this year.¹ The Senate is expected to pass the bill in the coming days.

If passed by the Senate and signed into law by President Obama, we expect that the bill will have a significant impact on the United States financial system. Significant areas of regulatory reform include:

- financial stability and regulation of “too big to fail” institutions;
- orderly liquidation procedures for troubled financial institutions;

- regulation of advisers to hedge funds and other private investment vehicles (including private equity funds);
- regulation of over-the-counter derivatives;²
- regulations concerning executive compensation and corporate governance;
- creation of a Consumer Financial Protection Bureau; and
- creation of a Financial Stability Oversight Council.

This alert focuses on the aspects of the Dodd-Frank bill that address the registration of investment advisers to hedge funds and certain other private pooled investment vehicles, as well as provisions that address certain sophisticated investor qualifications (such as the accredited investor standard) and the Volcker Rule, which purports to limit the ability of banks to engage in proprietary trading and invest in hedge funds and private equity funds.

Investment Adviser Registration

Section 203(b)(3) and CTA Exemptions

Title IV of the Dodd-Frank bill, known as the *Private Fund Investment*

Advisers Registration Act of 2010, contains a comprehensive overhaul of the registration regime for investment advisers. The bill eliminates the so-called “private adviser exemption” contained in Section 203(b)(3) of the Investment Advisers Act of 1940 that currently exempts from registration investment advisers with fewer than fifteen clients who do not hold themselves out to the public as investment advisers. Currently, this exemption is relied upon by most unregistered advisers to hedge funds and many other pooled investment vehicles. For investment advisers that advise “private funds” (i.e., any issuer that would be an investment company but for the exemptions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, including hedge funds and private equity funds), the Dodd-Frank bill also eliminates the “intrastate” exemption from registration. The intrastate exemption is currently available to advisers whose clients are residents of

a single state in which such adviser maintains its principal office and place of business. Unlike previous proposals that have been considered by Congress over the past year, the Dodd-Frank bill does not eliminate the CTA exemption. The CTA exemption concerns the current exemption available to investment advisers who are registered with the Commodity Futures Trading Commission as Commodity Trading Advisors and whose business does not consist primarily of acting as an investment adviser (as defined by the Advisers Act). The Dodd-Frank bill also contains an additional CTA exemption for investment advisers to private funds who are registered with the CFTC as Commodity Trading Advisors. This exemption is available so long as such investment adviser's business does not consist predominantly of the provision of securities-related advice (that is, if any adviser's business consists primarily of the provision of securities-related advice, this CTA exemption is not available).

Finally, the Dodd-Frank bill provides additional clarity around the SEC's rulemaking authority, giving the SEC the ability to define technical, trade and other terms used in the Advisers Act. However, the Dodd-Frank bill expressly provides that the SEC may not define the term "client," for the purposes of Section 206(1) and Section 206(2) of the Advisers Act (e.g., the anti-fraud provisions of the Advisers Act), to include any investor in a private fund managed by an investment adviser, if such private fund has entered into an investment advisory contract with the investment adviser.

Assets Under Management Threshold for Registration of Investment Advisers to Private Funds

The Dodd-Frank bill provides that any investment adviser who acts solely as an adviser to private funds and has assets under management in the United States of less than \$150 million, shall be exempt from the registration requirements under the Advisers Act. However, the Dodd-Frank bill directs the SEC to require such advisers to maintain records and provide to the SEC any reports that the SEC determines are "necessary or appropriate in the public interest or for the protection of investors."

The Dodd-Frank bill also provides that the SEC, taking into account the size, governance, investment strategy and risks imposed by any private fund, may impose registration and reporting requirements upon any investment advisers that fall below the \$150 million threshold if the SEC determines that such registration and reporting requirements are warranted.

Exemption for Investment Advisers to Venture Capital Funds and Small Business Investment Companies

Reflecting a concerted lobbying effort on the part of the venture capital industry, the Dodd-Frank bill exempts from registration investment advisers to venture capital funds. The Dodd-Frank bill directs the SEC to define the term "venture capital fund" for purposes of this exemption within one year of the bill's enactment. Complicating this task for the SEC is the fact that a similar proposal to exempt from registration investment advisers to private equity funds

contained in the Senate's financial reform proposal is not included in the Dodd-Frank bill. While investment advisers to venture capital funds may avail themselves of this exemption from registration under the Advisers Act, the Dodd-Frank bill directs the SEC to require such advisers to maintain records and provide any reports that the SEC determines are "necessary or appropriate in the public interest or for the protection of investors."

Recognizing the regulatory regime of the Small Business Investment Act of 1958, the Dodd-Frank bill also contains an exemption from registration for any adviser who solely advises a small business investment company licensed under that act.

Exclusion of Family Offices

The Dodd-Frank bill expressly removes family offices from the purview of the Advisers Act, thereby enabling investment advisers to family offices to avoid any registration or recordkeeping requirements under the Advisers Act. The Dodd-Frank bill provides that the definition of "family office" is to be defined by the SEC (i) to be "consistent with the previous exemptive policy of the [SEC], as reflected in exemptive orders for family offices in effect on the date of enactment" of the Dodd-Frank bill and (ii) to recognize "the range of organizational, management, and employment structures and arrangements employed by family offices." Generally, the SEC's exemptive orders are limited to family offices serving the lineal descendants of a single individual (including entities that are exclusively owned by or for

the benefit of such individuals). It is unclear whether the SEC will take a more narrow or expansive approach when defining “family office.”³ The Dodd-Frank bill also contains certain provisions that will “grandfather” the exemption from registration for advisers who were not registered, or required to be registered, as investment advisers solely because of the provision of investment advice to certain natural persons associated with a family office or certain entities, such as entities that are owned exclusively and controlled by members of the family of a family office. Advisers availing themselves of this exemption will, nevertheless, be subject to the antifraud provisions of Section 206(1), 206(2) and 206(4) of the Advisers Act.

Exemption for Foreign Private Advisers

The Dodd-Frank bill also amends Section 203(b)(3) of the Advisers Act by creating an exemption from registration for certain “foreign private advisers.” A foreign private adviser is defined as any investment adviser that (i) has no place of business in the United States, (ii) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the adviser, (iii) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the adviser of less than \$25 million, and (iv) does not hold itself out to the public in the United States as an investment adviser or act as an investment adviser to either a registered investment company or a company that has elected to be treated as a business development company under the Investment Company Act.

Expanded Recordkeeping and Reporting Obligations for Registered Investment Advisers

In its current form, the Dodd-Frank bill subjects registered investment advisers to private funds to certain expanded recordkeeping and regulatory reporting requirements. Under these expanded requirements, registered investment advisers will be required to maintain and (subject to SEC rulemaking) potentially report to the SEC information regarding assets under management, use of leverage, types of assets held, valuation policies, counterparty credit risk exposure, trading practices, side letters and other information that the regulators may determine is “necessary and appropriate in the public interest, and for the protection of investors or for the assessment of systemic risk.” The SEC, in turn, would make such information available (on a confidential basis) to the Financial Stability Oversight Council, a new, 10-member regulatory body created by the Dodd-Frank bill with ultimate responsibility for monitoring and addressing risks to the nation’s financial stability.

The Dodd-Frank bill expressly provides that the SEC shall conduct periodic examinations of any records of private funds maintained by registered investment advisers (whether or not such records are required by law to be maintained by the investment adviser) and provides, further, that the SEC may conduct additional discretionary or supplemental examinations of such records.

For investment advisers that are registered with both the SEC and

CFTC, the Dodd-Frank bill directs those agencies to jointly issue rules and regulations regarding the form and content of reports that are required to be filed with both agencies. These rules and regulations must be issued within one year of the enactment of the bill.

Assets Under Management Threshold for Investment Adviser Registration Generally

In a move that is likely to prompt a substantial wave of registrations at the state level, the Dodd-Frank bill contains a provision raising the assets under management threshold for investment advisers to register with the SEC from \$25 million to \$100 million. The increased threshold does not apply to an investment adviser to a registered investment company or a business development company, or an investment adviser who would be required to register with 15 or more individual states (in which case such investment adviser may instead voluntarily register as an investment adviser with the SEC).

Effective Date

The effective date of the registration regime contained in the Dodd-Frank bill is one year after the date of enactment of the bill, except that an investment adviser, subject to the rulemaking of the SEC, may voluntarily register with the SEC prior to such effective date.

Adjustment of Accredited Investor Standard and Qualified Client Standard

The Dodd-Frank bill directs the SEC to adjust the individual net worth

standard for accredited investors so that such individual's net worth (or joint net worth with such person's spouse) excludes the value of a primary residence.⁴ Beginning four years after enactment of the bill, in order to qualify as an accredited investor, an investor's net worth (excluding any primary residence) must exceed \$1 million. The new net worth standard is subject to periodic adjustments (presumably increases) as determined by the SEC.

The Dodd-Frank bill also (i) directs the SEC to conduct a mandatory review of the accredited investor standard after four years of the enactment of the bill,⁵ (ii) directs the Government Accountability Office to conduct a study within three years of the bill's enactment analyzing not only the accredited investor standard, but also any other criteria for determining "eligibility to invest in private funds," and (iii) directs the SEC to adjust for inflation, within one year of the enactment of the bill, the dollar amount used to establish the qualified client standard (and to adjust such dollar amount every five years thereafter).

Deadlines for SEC Examinations, Inspections and Enforcement Actions

Title IX of the Dodd-Frank bill, the *Investor Protection and Securities Reform Act of 2010*, requires that the SEC take definitive action in connection with SEC examinations, inspections and proposed enforcement actions within specified timeframes. In order to address situations in which matters have gone unresolved for extended periods, the bill provides that, once the SEC provides a Wells

notice to a potential target, the Commission has 180 days to file its case. Similarly, once the SEC has completed an on-site inspection or examination and receives all required records from an adviser, the SEC has 180 days to request corrective action or notify the adviser that the matter is concluded. Either of these deadlines can be extended for a second 180-day period on notice to the SEC Chairman and, with SEC approval, for any number of successive 180-day periods.

The Volcker Rule

As originally proposed during the earlier stages of the financial reform debate, the Volcker Rule would have strictly prohibited banks from trading their own proprietary accounts and engaging in private fund sponsorship and investment activities. While the Volcker Rule remains a fundamental part of the new legislation and contains extensive restrictions on proprietary trading and private fund sponsorship and investment, the final form of the bill includes significant exceptions to the original prohibitions as well as extended transition periods for compliance.

The Volcker Rule's statutory ban on proprietary trading⁶ by banking entities⁷ covers any security, any derivative, any future, any option on any of the foregoing, or any other security or financial instrument designated by rule by the federal regulators.⁸ As is the case with other elements of the legislation, the prohibition on proprietary trading is subject to a list of exceptions, referred to in this section of the statute as "permitted activities."⁹ Permitted activities include, but are not limited to (i) transactions in a broad range of

U.S. government securities; (ii) transactions "in connection with underwriting or market making-related activities, to the extent that any such activities ... are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties," (iii) transactions "on behalf of customers" and (iv) "risk-mitigating hedging activities."

The Volcker Rule's prohibition on sponsorship of or investment in hedge funds and private equity funds has similarly been scaled back. Pursuant to a "de minimis" exception, banking entities may still make investments in private funds of (i) not more than 3% of the total ownership of such fund within one year of the fund's establishment and (ii) not more than 3% of such banking entity's Tier 1 capital.¹⁰ While there are certain other enumerated restrictions and requirements with which banking entities must comply in order to invest in hedge funds or private equity funds, such as (i) disclosing to fund investors that the banking entity does not guarantee or insure the obligations of the fund and (ii) avoiding investments that involve material conflicts of interests or exposure to high-risk assets or high-risk trading strategies, the Volcker Rule, in its current form, would still allow banking entities to be involved in the organization of and investment in hedge funds and private equity funds, and is generally viewed as less stringent than many in the investment management industry had feared.¹¹

The Volcker Rule will not become effective until approximately two years after enactment (specifically, the earlier of (i) 12 months after the

issuance of final rules by the applicable federal agency or (ii) two years after the date of enactment). The Dodd-Frank bill also provides for a two-year transition period for banking entities to conform their activities to comply with the Volcker Rule, subject to the possibility of three one-year extensions. Subject to certain conditions, the bill also provides for an extended transition period for divestiture of investments in illiquid funds (up to a maximum of five years). The Dodd-Frank bill directs regulators to issue rules covering this transition period within six months of the enactment of the bill.

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Upon passage, the Dodd-Frank bill will usher in a new era of regulation of the United States financial sector and significantly affect the landscape of the investment management industry. Many investment advisers that are currently registered with the SEC may be forced to deregister and, in turn, register with a state or states and adhere to the compliance obligations that such registration(s) will entail.¹² Additionally, many unregistered investment advisers will be required to register with the SEC and become subject to the regulatory regime and compliance requirements associated with life as a registered investment adviser. Many investment advisers to pooled investment vehicles also may have to address the issue of investors who no longer meet certain qualification standards for investing in private funds (e.g., the accredited investor standard). Finally, considering

the possible ramifications of the Dodd-Frank bill, along with increased regulatory initiatives by the SEC, CFTC and state regulators, investment advisers will, at the very least, face increased compliance responsibilities, regulatory scrutiny and the costs associated therewith.

Because the bill directs various federal agencies to study, make recommendations and issue rules with respect to the implementation of all elements of the bill over the coming months and years, the ultimate scope and effectiveness of the Dodd-Frank Bill will depend on the rulemaking and the manner in which regulators seek to enforce the legislation.

We caution you that while we have attempted to summarize key highlights of the bill and its relevance to the investment management industry, the Dodd-Frank bill is more than 2300 pages long and the actual provisions detailed and complex. Lowenstein Sandler's Investment Management Practice Group will continue to monitor and report on developments relating to this historic legislation and the rule-making to follow.

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- ¹ The Lowenstein Sandler Investment Management Group Client Alerts analyzing the House bill and the Senate Bill are available [here](#) and [here](#), respectively.
- ² The Lowenstein Sandler Investment Management Group Client Alerts analyzing this portion of the Dodd-Frank bill and its possible effects on hedge funds that trade derivatives is available [here](#).
- ³ The bill does not provide a timeline for the issuance of the definition of "family office" by the SEC.
- ⁴ The Dodd-Frank bill does not address any "grandfather" provision that would apply to current investors in 3(c)(1) funds who would not meet the new standard.
- ⁵ The SEC may conduct a discretionary review of the Accredited Investor standard prior to this four-year date.
- ⁶ Proprietary trading is defined as "engaging as a principal for the trading account" of a covered banking entity in buying or selling any covered instrument.
- ⁷ "Banking entity" is defined as any insured bank or thrift, a company that controls such bank or thrift, any company that is treated as a bank holding company or any affiliate of such entity.
- ⁸ Covered instruments do not include commodities such as precious metals and energy products.
- ⁹ Permitted activities are subject to further rulemaking and restrictions, including the possibility of rules imposing capital requirements and quantitative limitations in order to "protect the safety and soundness of banking entities engaged in such activities."
- ¹⁰ The Volcker Rule also places certain quantitative restrictions and capital requirements on nonbank financial companies that engage in activities addressed by the Volcker Rule.
- ¹¹ The statute provides that regulators may impose additional restrictions in addition to those set forth in the bill.
- ¹² It is also unclear at this time how states will modify their own securities laws where they reference the current version of Section 203(b)(3) of the Advisers Act. For example, New York, California and Connecticut currently exempt investment advisers from investment adviser registration in each of these states respectively, if such advisers were eligible for federal registration but were not so registered in reliance upon the Section 203(b)(3) exemption.

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