

ClientAlert

Financial Markets Developments

July 2010

[Dodd-Frank Wall Street Reform and Consumer Protection Act](#)

The Private Fund Investment Adviser Registration Act Of 2010

On July 21, 2010, the comprehensive financial regulatory reform bill, referred to as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), was signed into law by President Obama. Title IV of the Act, the Private Fund Investment Advisers Registration Act of 2010 ("Title IV"), specifically addresses registration with, and reports to, the Securities and Exchange Commission (the "SEC") by investment advisers.

This Alert summarizes the key features of Title IV by providing answers to what we believe are the most critical questions that investment advisers will have regarding the new law.

1. Which entities are covered by Title IV?

Title IV covers certain "investment advisers," which are broadly defined in the US Investment Advisers Act of 1940, as amended (the "Advisers Act") as any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities, although the definition also includes a number of specific exclusions.

Many of the provisions of Title IV are particularly applicable to investment advisers to "private funds," which are defined in Title IV as issuers that would be investment companies under the US Investment Company Act of 1940, as amended (the "Investment Company Act") but for the exception provided by either Section 3(c)(1) or 3(c)(7) of that act.

2. What does Title IV require?

As discussed below, Title IV requires that certain investment advisers, including certain advisers to private funds, register with the SEC and/or comply with certain recordkeeping and reporting requirements.

3. What exemptions to SEC registration previously included in the Advisers Act have been eliminated by Title IV?

Title IV requires the registration of certain investment advisers that were previously exempt from registration by striking Section 203(b)(3) of the Advisers Act. That section, commonly known as the "private adviser" exemption, exempted from registration any investment adviser who, during the course of the preceding twelve (12) months, had fewer than fifteen (15) clients¹ and who neither held itself out generally to the public as an investment adviser nor acted as an investment adviser to a registered investment



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company or business development company. As a result, many investment advisers who advise less than fifteen (15) clients—including advisers who are not advisers to private funds—will now be subject to registration under Title IV unless they can meet another existing exemption or one of the new exemptions discussed below. To the extent that any adviser fits into an exemption from registration, it may still be subject to certain reporting and recordkeeping requirements as discussed in question 7 below.

In addition, investment advisers to private funds will no longer be able to rely on the so called “intrastate exemption” currently available under Section 203(b)(1) of the Advisers Act. Section 203(b)(1) provides that an investment adviser is exempt from registration if all of its clients are residents in the state within which such investment adviser maintains its principal office or place of business, and who does not furnish advice or issue analyses or reports with respect to exchange-listed or admitted securities. Under Title IV, this exemption will be unavailable to any investment adviser who acts as an investment adviser to any “private fund.”

4. Does Title IV provide any new exemptions to SEC registration on which investment advisers can rely?

Yes. Title IV includes the following new exemptions to registration:

Exemption for an investment adviser to private funds that has assets under management in the United States of less than US\$150 million

Investment advisers that act solely as advisers to private funds (as defined above) and have less than US\$150 million in assets under management in the United States will be exempt from registration. Neither the existing provisions of the Advisers Act nor the new amendments to the Advisers Act created by Title IV define “assets under management in the United States.” The SEC clearly has the authority to adopt a rule to define “assets under management in the United States,”² and we would expect, given its importance for purposes of relying on this exemption, that the SEC will provide some guidance (either in a rule or possibly in the form of “Frequently Asked Questions”). Based on past SEC guidance and interpretations, although possible, we believe it is unlikely that the SEC would consider the assets of a private fund organized and based outside of the United States to constitute “assets under management in the United States,” particularly where such private fund has no US investors.

Although exempt from the registration requirements, advisers who qualify for this exemption will be subject to SEC-mandated recordkeeping and reporting requirements as described in further detail below in question 7.

Limited exemption for foreign advisers

An investment adviser will be exempt from registration if it (a) has no place of business in the United States, (b) has, in total, fewer than fifteen (15) clients and investors in the United States in private funds advised by such adviser, (c) has aggregate assets under management attributable to clients or investors in the United States in private funds advised by such adviser of less than US\$25 million, or such higher amount as the SEC deems appropriate, and (d) neither holds itself out generally to the public in the United States as an investment adviser or acts as an investment adviser to a registered investment company or business development company. As described below in question 7, exempt foreign private advisers may still be required to file reports containing such information as the SEC deems necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk.

Note that this exemption is much narrower than the “fewer than 15 clients” exemption that non-US advisers to private funds previously relied on, as it calls on the SEC to count both the fund and its underlying investors towards the threshold for registration. It remains to be seen if the SEC will change its position that currently excuses a non-US adviser from complying with the regulatory requirements of the Advisers Act with respect to such adviser’s non-US clients.

Exemption for registration for venture capital fund advisers

Investment advisers that act solely as advisers to venture capital funds will be exempt from registration. Such advisers will, however, be subject to SEC-mandated recordkeeping and reporting requirements as described in further detail below in question 7. The SEC is directed to define the term “venture capital fund” by July 21, 2011.

Exemption for family offices

Family offices will be exempted entirely from the definition of “investment adviser,” and thus exempted from all provisions of the Advisers Act, including those pertaining to reporting. The SEC is directed to define the term “family office” in a way that recognizes the range, management and employment structures and arrangements employed by family offices and is consistent with its previous exemptive policy.

Exemption for advisers to small business investment companies

Title IV exempts from registration any investment adviser that has not elected to be regulated or is not regulated as a business development company and who solely advises (a) small business investment companies that are licensees under the Small Business Investment Act of 1958 (the "SBIA"), (b) entities that have received from the Small Business Administration notice to proceed to qualify for a license as a small business investment company under SBIA, which notice or license has not been revoked or (c) applicants that are affiliated with one or more licensed small business investment companies and that have applied for another license under SBIA, which application remains pending.

It is important to note that any adviser that is exempted from federal registration requirements may be required to register in one or more states.

5. Will the registration and examination requirements be the same for all investment advisers?

Perhaps not. With regard to advisers to "mid-sized private funds," the SEC is directed to take into account the size, governance and investment strategy of such funds to determine whether they pose systemic risk and adjust its registration and examination procedures accordingly. The SEC will presumably be required to define the term "mid-sized private funds," as such term is not defined in Title IV. The shape of any such adjusted registration or examination procedures is unclear and may, or may not, be addressed in the SEC rulemaking process.

6. Does Title IV include any new recordkeeping and reporting requirements for registered advisers?

Yes. In addition to the current recordkeeping and reporting requirements for all registered advisers, Title IV amends the Advisers Act to require certain additional recordkeeping and reporting by registered investment advisers to private funds. Registered private fund advisers will be required to maintain, report and make available to the SEC such information regarding the private funds they advise as the SEC determines is necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by a newly-created multi-agency Financial Stability Oversight Council (the "Council"), and the SEC is authorized to share such information with the Council as discussed further below in question 8.

At a minimum, each registered investment adviser to a private fund will be required to record and make available, for each private fund advised by such adviser, information regarding (a) the amount of assets under management and use of leverage, including off-balance-sheet leverage, (b) counterparty credit risk exposure, (c) trading and investment positions, (d) valuation policies and practices, (e) types of assets held, (f) side arrangements or side letters and (g) trading practices. In addition, the SEC and the Council may require the maintenance and reporting of such other information as they jointly determine necessary and appropriate, as well as establish different recordkeeping and reporting requirements for different classes of advisers based on the type or size of private fund being advised.

As is the case with the type of information required to be maintained, the period of time that an adviser will be required to maintain such information will be prescribed by the SEC based on what it determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

7. Does Title IV include any new recordkeeping and reporting requirements for unregistered advisers?

Yes. An adviser that is exempt from registration either because (a) it has assets under management in the United States of less than US\$150 million and solely advises private funds or (b) it solely advises venture capital funds, will be required to maintain such records and provide such reports to the SEC as the SEC determines necessary or appropriate in the public interest or for the protection of investors. Title IV does not specify the types of recordkeeping and reporting that will be required of these particular exempt advisers but mandates that the SEC determine such requirements. Any such recordkeeping and reporting requirements that the SEC does promulgate could include many or all of the requirements discussed above in question 6.

Additionally, Title IV requires the SEC to issue rules requiring each investment adviser to a private fund to file reports containing such information as the SEC deems necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk. Although not explicitly stated, presumably such reports would be filed with the SEC. This provision gives the SEC particularly broad authority with respect to any investment adviser to a private fund, without regard to whether such adviser is registered with the SEC or a state. The SEC may provide clarity on how it interprets this authority in the rulemaking process.

8. Will information provided by an investment adviser to the SEC be made publicly available?

Certain information of an investment adviser provided to the SEC will become publicly available. Section 210(a) of the Advisers Act provides that the information contained in an adviser's registration application or report or amendment thereto filed with the SEC (which, as discussed below in question 15, had only referred to Part 1 of an adviser's Form ADV) may be made available to the public. Pursuant to the new SEC rule discussed below in question 15, Part 2 of the Form ADV will now also be publicly available. With respect to the new reporting requirements for advisers to private funds as described in questions 6 and 7, Title IV explicitly requires the SEC to maintain the confidentiality of such information, although it must share such information with the Council as the Council considers necessary for the purpose of assessing the systemic risk posed by a private fund. The Council is generally required to maintain the confidentiality of such information.

Additionally, the Advisers Act protects an adviser from being required to disclose the identity, investments or affairs of any client unless such disclosure is necessary or appropriate in a particular proceeding or investigation with respect to enforcement of a provision of the Advisers Act. Title IV expands the carve-out in the previous sentence so that the SEC may also require such disclosure for purposes of the assessment of potential systemic risk.

Despite the confidentiality provisions described in the previous paragraphs, it will be important to examine the rules that the SEC adopts in this regard in light of the broad general rulemaking authority given to the SEC in Title IV, particularly as it relates to the new Form ADV amendments discussed below in question 15.

9. Does Title IV include any new SEC examination procedures?

The SEC must conduct periodic inspections of the records of private funds maintained by an SEC-registered investment adviser in accordance with a schedule to be established by the SEC. Further, the SEC may conduct at any time such additional, special and other examinations as the SEC prescribes as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk. Title IV does not specifically limit the additional and special examinations discussed in the previous sentence to private funds, advisers to private funds or even to registered advisers as a whole; therefore, although not entirely clear, the SEC may ostensibly conduct such examinations with respect to registered and unregistered investment advisers. We expect that further light will be shed on this requirement through the rulemaking process.

10. How does Title IV affect the US\$25 million assets under management threshold that previously dictated whether an adviser may register with the SEC?

Until Title IV becomes effective, under Section 203A of the Advisers Act, an investment adviser that is registered or required to be registered in the state in which it maintained its principal office is not permitted to register with the SEC unless it has at least US\$25 million in assets under management, or acted as an adviser to a registered investment company. Rule 203A-1, promulgated by the SEC under the Advisers Act, provides that an investment adviser that has assets under management of at least US\$30 million must register with the SEC.³ Under Title IV, however, if an investment adviser has between US\$25 million and US\$100 million in assets under management (or such higher amount as the SEC may deem appropriate), such adviser is not permitted to register with the SEC, unless such adviser would be required to register with fifteen (15) or more states. In order to address this inconsistency, we anticipate that the SEC will have to amend Rule 203A-1 or promulgate a new rule that requires advisers with US\$100 million (or a higher amount) in assets under management to register with the SEC.

This change, which generally serves to shift a portion of the regulatory burden from the SEC to various state regulatory authorities, may also require certain advisers that are currently registered with the SEC to de-register and instead register with one or more states.

11. Does Title IV address the current accredited investor standard defined in Regulation D under the Securities Act of 1933, as amended, and the qualified client standard defined in rules promulgated under the Advisers Act?

A. Accredited Investor Definition

Yes. Title IV directs the SEC to adjust the net worth standard for an accredited investor under its rules to be, for the individual net worth of any natural person or joint net worth with the spouse of that person, more than US\$1 million (as such amount is adjusted periodically by the SEC), excluding the value of the primary residence of such person (the current test *includes* the primary residence in the net worth threshold), provided that from July 21, 2010 until July 21, 2014, such net worth standard must be US\$1 million, excluding the value of the primary residence of such person.

The SEC may also review the requirements of the accredited investor standard as it applies to natural persons, other than the net worth threshold discussed above, to determine whether the requirements should be adjusted for the protection of investors, in the public interest, and in light of the economy. Not earlier than July 21, 2014, and not less frequently than once every four (4) years thereafter, the SEC must undertake a review of the entire definition of accredited investor as it applies to natural persons.

B. Qualified Client Definition

Monetary thresholds for the so-called qualified client standard are currently provided under Rule 205-3 to the Advisers Act, which states that an investment adviser may generally only enter into an advisory contract with performance based compensation with a client who (a) has at least US\$750,000 under the management of the investment adviser, (b) has a net worth, together, in the case of a natural person, with assets held jointly with a spouse, of US\$1.5 million, (c) is a qualified purchaser as defined in Section 2(a)(51)(A) of the Investment Company Act or (d) is a natural person who immediately prior to entering into the advisory contract is an executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser or an employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company, for at least twelve (12) months). Title IV directs the SEC to periodically adjust for inflation, by July 21, 2011 and every five (5) years thereafter, the dollar amount measures used in the qualified client test.

12. What studies are required by Title IV?

Title IV requires the Comptroller General of the United States to conduct studies on: (a) the appropriate criteria for determining the financial thresholds and other criteria needed to qualify for accredited investor status and eligibility to invest in private funds, the results of which must be reported to the House and Senate no later than July 21, 2013; and (b) the feasibility of forming a self-regulatory organization to oversee private funds, the results of which must be reported to the House and the Senate not later than July 21, 2011.

The SEC will be required to conduct studies on: (i) the state of short selling on national securities exchanges and the over-the-counter markets, the results of which must be reported to the House and the Senate not later than July 21, 2012; and (ii) the feasibility of (A) requiring public reporting of real-time reporting of short-sale positions in publicly listed securities or (B) conducting a voluntary pilot program whereby public companies would agree to real-time reporting of all positions in their shares, the results of which must be reported to the House and the Senate not later than July 21, 2011.

The SEC must also report annually to Congress on how the SEC has used the data collected pursuant to the new private fund recordkeeping and reporting requirements discussed above to monitor the markets for protection of investors and the integrity of the markets.

13. Were there provisions that were discussed in either the House or the Senate that were ultimately not included in Title IV?

Yes. The following are a few key provisions that were proposed by either the House or the Senate but were ultimately dropped during the reconciliation process:

- **Exemption for private equity fund advisers.** A specific exemption from registration for private equity fund advisers (who would still have been subject to recordkeeping and reporting requirements) was included in the Senate bill, with the SEC being directed to define "private equity fund."
- **Disclosures to third parties.** A provision in the House bill would have required advisers to private funds to provide such information to investors, prospective investors, counterparties and creditors of such private funds as the SEC deemed appropriate for the protection of investors or the assessment of systemic risk.
- **Independent custody of client assets.** A provision in the House bill that would have barred investment advisers from having custody of client assets over US\$10 million, subject to SEC exemptive authority if such assets were audited at least annually by an independent entity with fiduciary responsibility to the client, was replaced by the Senate bill's general mandate that registered investment advisers comply with SEC rules regarding the safeguarding of client assets.
- **Registration requirement for CTAs that advise private funds.** The House bill would have required investment advisers that are registered with the Commodity Futures Trading Commission as Commodity Trading Advisers who did not primarily act as investment advisers to nevertheless also register under the Advisers Act if they acted as investment advisers to private funds.

14. Upon making the determination that an adviser must register with the SEC, what is the process required to register as an investment adviser with the SEC?

The mechanical process of registration as an investment adviser with the SEC, to the extent it does not change further pursuant to the SEC rulemaking process, is initiated by filing a completed application on Form ADV, with the Investment Adviser Registration Depository (the "IARD"), a computer system operated by the Financial Industry Regulatory Authority ("FINRA").

15. What is required to be disclosed on the Form ADV?

Currently, the Form ADV contains two parts. Part 1 is filed with the SEC and Part II, also known as the "brochure," is only provided to clients and potential clients of the adviser, not to the SEC. On July 21, 2010, however, the SEC unanimously voted to adopt amended rules with respect to the Form ADV (the "Form ADV Rule")⁴ that will, among other things, require an adviser to electronically file the brochure (now known as Part 2 of the Form ADV), which will become publicly available on the SEC's website.

Although changes to the brochure portion of the Form ADV have been discussed at the SEC for a number of years, the Form ADV Rule represents a significant departure from current practice. First, the Form ADV Rule expands the categories of information that investment advisers are required to disclose (although the extent of such disclosure will not be entirely clear until the Form ADV Rule is publicly available). Second, all of the information included in an investment adviser's Part 2 of the Form ADV (in addition to Part 1, which is currently publicly available) will now be publicly available.

The current Form ADV requires disclosure of information, including, but not limited to, (a) the identity, prior business history and associations of the owners, directors, partners, officers and certain employees of the adviser, (b) the types of businesses in which the adviser engages or intends to engage, (c) the sources of funding for the adviser's business and (d) the nature of the relationship between the adviser and any person or entity which "controls" the adviser. The Schedules to the Form ADV require the adviser to identify all "controlling persons" (i.e., officers, directors and certain shareholders).

The Form ADV Rule will require additional disclosures of information, including, but not limited to, (i) additional details of an investment adviser's advisory business (including the types of advisory services offered, whether the adviser holds itself out as specializing in a particular type of advisory service and the

amount of client assets that the adviser manages), (ii) fees and compensation (including performance-based fees, brokerage fees, custody fees, and fund expenses that clients may pay in connection with the services provided), (iii) methods of analysis, investment strategies and risk of loss, (iv) code of ethics, participation or interest in client transactions, and personal trading and (v) brokerage practices. All of this information will be required to be filed with the SEC and made publicly available

The Form ADV Rule will be effective sixty (60) days after its publication in the Federal Register, but it is not expected to affect currently registered advisers until the first quarter of 2011. We will need to wait until the Form ADV Rule and the amended Form ADV are publicly available in order to assess its full impact on SEC-registered investment advisers, including the impact on the confidentiality protections currently provided to advisers as discussed in question 8 above.

16. What are the implications of Title IV on state regulatory regimes?

A. Adviser Registration

As described above in question 10, the increased threshold for federal registration to US\$100 million will likely cause many mid-sized investment advisers to be required to register at the state level.

Many states' exemptive provisions refer to the "fewer than 15 client" exemption in Section 203(b) in their exemptions (e.g., if an adviser is exempt from federal registration pursuant to the fewer than 15 client exemption, such adviser is not required to register with the state if other conditions are met). Because Title IV removes the fewer than 15 client exemption in Section 203(b), we expect many states to address this anomaly through guidance or interpretation over the next several months. We also expect the North American Securities Administrators Association ("NASAA") to develop model rules which will likely be adopted in many states.

17. What is the transition period during which investment advisers are able to adopt the policies and procedures necessary to comply with Title IV?

The provisions of Title IV will become effective on July 21, 2011. Investment advisers that will be subject to registration under Title IV will be allowed to voluntarily register with the SEC during the one-year transition period.

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Next Steps

On July 21, 2010, President Obama signed the Act into law. Despite its enactment, many of the details of how Title IV will be implemented, including the responsibility to define certain key terms, has been left to the SEC. As discussed above, Title IV gives the SEC, particularly broad discretion with respect to the rulemaking it must undertake regarding advisers to private funds. Among other things, the SEC will have broad discretion to (a) define and interpret certain key terms, including “venture capital fund” and “mid-sized private fund,” (b) establish adjusted registration and examination procedures for certain advisers and (c) establish recordkeeping and reporting requirements for certain advisers as it deems necessary and appropriate in the public interest, for the protection of investors and/or for the assessment of systemic risk. Thus, many aspects of the mechanics of investment adviser regulation will remain uncertain until the SEC enacts rules implementing Title IV’s provisions.

Despite the one-year transition period before Title IV takes effect and the numerous rules that will need to be enacted by the SEC regarding the mechanics of the various provisions, unregistered investment advisers should consider starting to devote resources to their compliance practices in preparation for registration.

We will continue to monitor the regulatory developments relevant to registration and will keep you apprised of the SEC’s rulemaking activity with respect to the implementation of Title IV.

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1. By way of background, the SEC issued a rule in 2004 that defined the term “client” for purposes of counting clients toward the fewer than 15-client exemption to include the underlying investors of hedge funds (*i.e.*, private funds that permit owners to redeem any portion of their interests in such private fund within two years of the purchase of such interests). The effect of the rule was that many advisers to hedge funds were required to register under the Advisers Act until the *Goldstein v. SEC* decision in 2006, where the DC Circuit Court of Appeals held that the SEC did not have the authority to issue such a rule. Title IV explicitly provides that the SEC may not define the term “client” for purposes of the anti-fraud provisions of the Advisers Act to include an investor in a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser. The inclusion of this language reflects Congress’s recognition that creating a fiduciary duty to both a private fund and its various underlying investors could result in an irresolvable conflict for an investment adviser.
 2. For purposes of Section 203A of the Advisers Act, which sets forth the minimum assets under management threshold to qualify for SEC registration (as opposed to state registration), “assets under management” are defined as “the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory and management services.”
 3. Prior to the effectiveness of Title IV, investment advisers with assets under management in an amount between US\$25 million and US\$30 million that do not advise a registered investment company are permitted to register with the SEC.
 4. The SEC’s press release regarding the Form ADV Rule is available at <http://www.sec.gov/news/press/2010/2010-127.htm>.

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